

BECOME YOUR OWN FINANCIAL ADVISOR



REAL
The secrets to becoming
FINANCIALLY INDEPENDENT

WARREN INGRAM

FOREWORD BY BRUCE WHITFIELD

BECOME YOUR OWN FINANCIAL ADVISOR



REAL
The secrets to becoming
FINANCIALLY INDEPENDENT

WARREN INGRAM

FOREWORD BY BRUCE WHITFIELD

BECOME YOUR OWN FINANCIAL ADVISOR

— ^{REAL} —
The secrets to becoming
FINANCIALLY INDEPENDENT

WARREN INGRAM



Published by Zebra Press
an imprint of Random House Struik (Pty) Ltd
Reg. No. 1966/003153/07
Wembley Square, First Floor, Solan Road, Gardens, Cape Town, 8001
PO Box 1144, Cape Town, 8000, South Africa

www.zebrapress.co.za

First published 2013

Publication © Zebra Press 2013

Text © Warren Ingram 2013

Cover image © iStockphoto/malerapaso

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior written permission of the copyright owners.

PUBLISHER: Marlene Fryer
MANAGING EDITOR: Ronel Richter-Herbert
EDITOR: Lisa Compton
PROOFREADER: Ronel Richter-Herbert
COVER DESIGNER: Monique Oberholzer
TEXT DESIGNER: Jacques Kaiser
TYPESETTER: Monique van den Berg

ISBN 978 1 77022 618 0 (print)
ISBN 978 1 77022 619 7 (ePub)
ISBN 978 1 77022 620 3 (PDF)

Contents

Acknowledgements

Foreword by Bruce Whitfield

Introduction

- 1 Financial Freedom
- 2 Starting Out
- 3 Building Up and Balancing Out
- 4 Retirement
- 5 The Entrepreneur: How to Plan Your Finances
- 6 Budgeting and Debt Management
- 7 Step Away from that Property
- 8 Investments 101
- 9 Investment Options
- 10 Insurance
- 11 Taxes, Trusts and Wills
- 12 Getting Help from Financial Professionals
- 13 Money and Relationships
- 14 Financial Blunders to Avoid

Bibliography

Acknowledgements

I would like to thank my wife and best friend, Vanessa Ingram. I could not have wished for a better companion – you make me a better man and I am grateful to you every day.

I would also like thank my parents, Bruce and Sarah Ingram, who had the patience and care to love a troubled child when he needed it most.

I would be remiss if I did not mention my teachers and hostel masters at Rondebosch Boys' High School. The proceeds of this book will hopefully enable a few boys to have the privilege of attending Bosch.

To the three men who gave direction to my career, anything that I have achieved is to your credit. Martus Claassen, who had faith in a young man when everyone else doubted. The late Nigel Scott, who gave me a vision of what financial planning should be and the courage to realise that vision – I miss your guidance every day. Lastly, to my business partner Theo Vorster, who has always treated me with integrity, patience and wisdom – you are a rare human being indeed.

To all the financial professionals who put their clients first, you know who you are and you know what we face every day. Please keep going, because you are making people's lives better.

There is no more knowledgeable, hardworking or ethical financial journalist in South Africa than Bruce Whitfield. Thank you for supporting this book and our fundraising efforts.

I have always wondered why writers acknowledge their editors, but after writing this book, I finally understand! To Mandy Collins, thank you for your help and motivation – all writers need someone like you. Lisa Compton, who was the editor appointed by the publishers, took a very rough diamond and shaped it into something better. To Marlene and Ronel at Zebra Press, thank you – let's hope our efforts are successful.

My colleagues at Galileo Capital, who epitomise everything that is good in financial services, you make me proud.

To Daniel R. Wessels, Dr Jannie Leach, Reg Thompson and John Campbell, thank you for always taking the time to share your ideas about our industry; I hope I have always reciprocated.

Lastly, to all my wonderful clients and industry friends who have spent time with me over nearly two decades – you allowed me to learn my craft with you and hopefully we are all better off as a result.

WARREN INGRAM

Foreword

‘Common sense,’ my grandfather used to say, ‘is not that common.’

Warren Ingram’s book is full of common sense. In many ways it is about the stuff you already know, but don’t always apply in your everyday life.

You know that spending more than you earn is a bad idea. You know that you don’t need a new car just because the motor plan has expired. You know that it is not necessary to upgrade the lounge suite just because it’s not as trendy as that of your new friends the Khumalos. But you do it anyway.

As South Africans we are far too often focused on the short-term ‘feel-good’ rewards of our labours. Our society tells us that we need to show our value through the cars we drive, the homes we live in, the watches we wear and the designer clothes that adorn our children. Those things make us feel good about our place in the world, but we fall into the trap of visible consumption at our peril and ignore the longer term in the mistaken belief that the future will somehow take care of itself.

If it was that easy, then this book would not be necessary. But this book is necessary.

I was fortunate to grow up in a home where the concept of money as a tool was discussed. We were far from rich, but the discussions of the importance of savings, the power of compounding, and the value of working hard to acquire assets were all had around the dinner table. The more people I meet, the more I realise how lucky I was to learn real-life lessons from people who were learning from their own successes and mistakes.

Warren has included these sorts of lessons in the pages that follow. This book is full of real-life examples and clear, no-nonsense guidelines that will open your eyes to the magic of making your money make you money.

There are many so-called gurus of financial enlightenment. Most of them happen to be American, and while the principles they espouse may be universal, they are too distant from our everyday reality to be truly relevant. In fact, there is no ‘one size fits all’ philosophy that will ensure that you have a solid financial future, but the principles described in this book can help guide you and your family to a greater level of financial prosperity.

If you could hold down two jobs, imagine how much better off you would be! Well, rather than work yourself to the bone, why not make your current income

work for you? In so doing, you will find over a period of time that your money is making money while you are getting the much-needed sleep you require to stay sane in our increasingly demanding world.

There are no short cuts. No one I know has become sustainably rich by following fads and trends. People who develop wealth over time do some incredibly boring things with discipline and repeat the process over and over.

Warren Ingram is not a guy to sugar-coat the truth. He will tell you inconvenient truths you may not want to hear. But he is a rare individual in that he speaks sense about money without relying on jargon.

For years I was an avid reader of *Men's Health* magazine – but I didn't become any healthier. It turns out that working out vicariously doesn't do the job. Similarly, this book will not make you rich. The opportunity to grow your wealth and achieve financial independence starts with you. *Become Your Own Financial Advisor* is a guide for you to follow, with solid principles for you to apply. The application and the hard work are for you to do.

Back to my grandfather: 'Never give advice. Wise men don't need it and fools won't take it.'

The choice lies with you.

BRUCE WHITFIELD

SANDTON

For Vanessa

Introduction

Money is central to all our lives. For better or worse, we all need money to operate in this world. And inevitably, those who can use and control their money wisely lead better lives than those who are enslaved by their money problems.

This book aims to help you understand how money works and, more importantly, what you should do to ensure that you control your money. Most people live their lives being controlled by their money problems. Taking control of the way you spend, save and invest your money is critical if you want to become financially independent.

This is not a how-to-get-rich-quick manual. If you follow the principles laid out in this book, you can certainly become financially independent and you may even become wealthy, but it won't happen quickly unless you are supremely lucky!

The only way to get rich quickly (and legally) is to marry a wealthy person, inherit a large fortune, win the lottery, risk more than most and get lucky, or start a successful business of your own. As a business owner myself, I certainly recommend that people consider starting their own businesses if they have the inclination, ability and perseverance. But even successful entrepreneurs need to learn how to manage their personal finances effectively. And you will quickly realise as you read this book that working with money is actually quite simple. (Just read any interview with Warren Buffett, perhaps the most successful investor of the 20th century, to see what I mean.) But – and it's a big 'but' – that doesn't mean it is easy. Very few people in the world become financially independent, because most people struggle to stick to the basic discipline of money management. It takes consistent work over a long period of time to become financially independent.

Most of us find it extremely difficult to be self-disciplined and prefer instant gratification instead. That is why we are becoming less healthy as a population and why most people will not be financially free. Instead, most people will be slaves to their bosses or their money troubles for their entire adult lives. I find this a very depressing thought, and it was possibly my greatest motivation for writing this book. I hope *Become Your Own Financial Advisor* will help at least a few people to change their current reality so that they can ensure a better future for themselves and their offspring.

HOW TO USE THIS BOOK

.....

I have structured this book to make it as user-friendly as possible. There are chapters aimed at people in certain stages of life (starting out, mid-career and retirement) so that you can refer directly to the chapter that is most appropriate for you. In addition, there are chapters focusing on specific topics – budgeting, investments, insurance, and so on.

I suggest that you use this book as a reference manual when you need to make specific decisions about money. And if you are married or in a serious long-term relationship, I suggest that both people in the relationship read the book and agree on a plan for managing your money. If I have learnt one thing about relationships and finances, it is this: both parties have to honestly agree on what they are going to do with their money. Because money troubles can be such a destructive force in a relationship, it is better to ensure that you and your partner work as a team when it comes to managing your finances.

In my marriage, it is my wife who controls the budget. She is much more conservative with expenditure, while I am more impulsive and need her restraint to balance my urges to spend our money on travel and holidays. At the same time, I love investments and tend to take the lead with our investing. We discuss and agree on our long-term plans, but I am the one who is responsible for researching and implementing our investment strategy.

MAKING MONEY IS PART SCIENCE AND PART ART

Mathematicians, economists and other scientifically minded people have tried to reduce the world of finance to a set of calculations, financial models or other computer simulations. Often these people have developed theories about the financial world and have become so convinced of the validity of their models that they take massive risks in anticipation of the ‘inevitable’ rewards. This is usually when catastrophe happens.

Rational financial models can partly explain the world of money, but one cannot underestimate the human aspect. Money is spent and controlled by human beings. And while people are usually quite rational when they are not under pressure and they are not in a crowd, the moment you put people into crowds and add stress, you can be certain that they will not be rational. This means that anyone who makes long-term financial decisions needs to anticipate the madness of the crowd – otherwise known as the market.

I believe the only way to insulate yourself from the madness is to develop your own plan for your money that is not dependent on short-term thinking. In

addition, I believe it is impossible to predict accurately what is going to happen to stock markets over any period, be it 24 hours or 10 years.

I am quite confident that markets are reasonably rational over longer periods, but I am equally confident that they can be completely irrational over shorter time frames. This is where the art of working with money begins. You need to be able to distinguish between the noise of the financial markets (usually any financial news) and real information (usually provided in books and other formats that are less time sensitive). If you can do that, you will be able to invest your money and grow it successfully. That journey starts right here.

WHERE WILL THE MONEY FROM THIS BOOK GO?

Every cent of the money that I earn from this book will go to the Serendipity Trust, a non-profit organisation started by my wife and me to fund education for children and young adults.

The beneficiaries of this trust are highly deserving young people who are not superstars in sport, academics or cultural activities. Instead they are all-rounders: respectable and hard-working young people who will hopefully make a long-lasting contribution to their respective communities.

If you would like to learn more about the Serendipity Trust, please go to the website www.serendipitytrust.co.za.

1

Financial Freedom

With massive developments in medical science and technology over the last few decades, we are all living longer. This increase in longevity is making the concept of a traditional retirement obsolete.

There are two reasons for this. First, we are generally much healthier at age 65 than our grandparents were, and therefore we have no urge to stop working in order to sit at home doing nothing. Second, most of the world's population will not be able to afford living without an income for 30 or 40 years after retirement.

More and more people are aiming to work for as long as possible, but they want to do so on their own terms. This is where the concept of financial freedom plays an important role. If you are going to be working for 40 to 50 years, it is important that you try to ensure that your work is enjoyable and that you are not a slave to your salary. This is why financial freedom is such an important goal: it will help you to have the financial means necessary to enable you to make choices about your life.

I was once asked by a university student why it is so important to spend so much time and energy on savings and investments. The student pointed out that very often it seems that investors receive no reward for their efforts. The point was made that people derive pleasure from spending money on holidays, clothes, cars and entertainment, so why should they invest? This is a key question that most of us deal with every day in our own lives when we decide whether to buy, save or invest. Without a clear goal to inspire us, most people will spend rather than save.

WHAT IS FINANCIAL FREEDOM?

Complete financial freedom is when the income from your assets exceeds your expenses. This is quite a different concept from being wealthy. Some people have financial freedom with assets of R5 million, while others who have assets of R50 million are not financially free. It is not possible for everyone to become truly wealthy (despite the Hollywood fairy tales), but anyone can be financially free.

I have met many people who have retired with relatively small amounts (under R5 million in investments plus a paid-off home) who are living fantastic lives as retirees. The real secret to their success is that they have (1) accumulated sufficient wealth, or capital as we say in the world of finance, to cover their expenses and (2) controlled their spending.

There are various degrees of financial independence, but probably the most crucial step towards financial freedom is to become debt free. Most people struggle to get past this step because they constantly increase their debt burden as their income increases. Because of this behaviour, many high-income earners in South Africa are typically three months away from financial difficulty in the event of a loss of income. As they get salary increases, they buy more expensive vehicles and houses because they can afford the higher monthly payments, but they don't pay off their debt until it is too late. If you can break this cycle by limiting your debt and paying it off more quickly as your income increases, you are already 80% of the way to financial freedom.

Another key step to financial freedom is to create a cash safety net. That is, you need to build an emergency fund for use in the event of a financial disaster. You should aim for an amount that is equivalent to half your annual expenses (it can be less if you have other assets that are easily accessible), and this should be saved in an interest-bearing account that allows you relatively easy access to your fund, such as a fixed-deposit account, money market account or 30-day notice account.

The next step is to start building your income-generating assets that will eventually pay your expenses in future. This is the step that most people focus on – that is, deciding where you should invest your money to get the most growth with the least risk – and we'll be looking at various investment options later on in this book.

But there's one implicit aspect that most people ignore about this step: you need to have completed the previous steps *before* you start investing. I often struggle to convince high-income earners that they must pay off their debts before concerning themselves with investing. They tend to feel that this approach is too slow and overly cautious, and that their income and investments will grow so well they need not concern themselves with debt. While there is some merit in this view, I have seen so many people lose their jobs or businesses unexpectedly that I strongly urge you to limit or pay off your debt first before focusing on investing.

There is one golden rule with money and it applies to any person at any stage of life or wealth: *you must always spend less than you earn*. If you want to be sure that you are saving enough to achieve financial independence and a

comfortable retirement, aim to save at least 15% of your total annual salary, every year, over your lifetime. It is not good enough to save only late in life; you need to be disciplined from the start. If you have been working for a few years and have not yet accumulated savings, start now!

It is important to understand that your initial asset base will take the longest to build because the benefit of compounding works in your favour over the longer term. The principle of compounding is most simply explained by an example. When you place R1 000 in a bank account where it earns interest at 6% per year, you will earn R60 in interest at the end of one year. However, if you leave the interest that you earned in the bank and it gets added to your R1 000 at the end of year one, you will earn R63.60 in interest the second year. The reason you earn more in year two is because your interest is also earning interest: this is known as *compounding*.

So, if you are very disciplined and save aggressively, it will probably take about eight years to save your first R1 million. This assumes that you are able to save R5 000 per month for eight years and you invest all the money in shares. Over the long term, shares grow at 15% per year, which is why someone saving R5 000 per month, or R60 000 per year, can have R1 million after eight years. But if you continue to save aggressively, your second million will take only five years, and your third million will take only three years. This is because of the effect of compound growth – it is your greatest ally and will be the tailwind that helps push you to attain your financial goals. As any cyclist will tell you, you need to keep pedalling when you have a tailwind. The best way to keep pedalling when you are dealing with investments is to be patient and maintain your financial discipline.

FINANCIAL FREEDOM IS POSSIBLE FOR ANYONE

If you need R10 000 per month to cover your expenses, you will require only R2.7 million in investments to be financially free for the rest of your life. However, if you need R50 000 per month for expenses, you will need more than R13.6 million in investments. (Just to clarify, the R2.7 million and the R13.6 million do not include the value of your home and vehicles.) I calculate this by multiplying your monthly expenses by 12 to get an annual amount (e.g. $R10\,000 \times 12 = R120\,000$) and then I divide this by 4.44% to get the value of the assets required ($R120\,000 \div 4.44\% = R2\,702\,702$). The reason I use 4.44% is that this is a sustainable amount of income to withdraw from a diversified asset

base over time. At a withdrawal rate of 4.44% per year, your asset base is likely to last over your lifetime even if you live through a major stock-market collapse. The important point here is that the real secret to financial freedom is to ensure that your expenses are as low as possible. Far sooner than you think, this will put you in a position where you don't need to earn a salary to survive.

Now I realise that most people don't want to live on R10 000 a month, but if you can get to this position, you will be able to make better decisions about your life without worrying about a salary. Most people who reach this position are able to change their lives substantially – for a number of good reasons:

- You have less stress because you don't have to generate a salary every month.
- You have the freedom to do the work you choose – for example, start a business.
- You can do a job you like rather than a job you hate.
- If you have a lousy employer, you can quit your job and take the time to find a workplace that suits you.

The only way you will have the necessary patience and discipline to take the steps to financial freedom I have outlined is by giving yourself a goal to work towards. Try to identify what will motivate you to spend less every month and not to buy the biggest house or fanciest car you can afford. Make this goal your priority and every time you get the urge to spend, think of your goal. Within a few years, you will be well on your way to financial freedom.

Each of us is unique and our issues around finances will be different, but almost all of us have the same expectation when it comes to money – that it will provide us with financial freedom. Unfortunately, this expectation is rarely fulfilled: less than 10% of any country's population will achieve this goal. Yet, while I would never suggest that it is easy to be financially free, it is certainly not beyond your reach. You only have to follow a few simple rules over your lifetime:

Rule 1: Be free of bad debt at all times. And I don't mean the kind of bad debt that is written off by companies when people fail to pay their debts. When I talk about bad debt, I mean the kind of debt you incur when buying things such as clothes, appliances, holidays and furniture.

In other words, bad debt is when you use debt to buy things that will be consumed or will not appreciate in value over time. Most people don't manage to stay free of bad debt because they can't bear to be without things that they absolutely 'need'. Normally, the problem gets bigger as our income rises, because we increase our debt along with our income.

However, as noted earlier, if you can limit your debt and use your pay increases to pay it off more quickly, financial freedom will be within your grasp.

Rule 2: Build an emergency fund that you can use in the event of a financial emergency. As mentioned above, aim for the equivalent of half your annual expenses and save it in an interest-bearing account such as a money market account. Choose an account that gives you access to your fund relatively quickly, but not so easily that you are tempted to dip into your nest egg for frivolous spending.

Note that this emergency fund is not an investment, but rather your own insurance against disaster. It will keep you from having to sell investment assets at the wrong time to pay for an emergency or unforeseen event. While I prefer a large emergency fund, you can have a smaller fund if you have saved extra money in your home-loan account and have ready access to it. Some advisors recommend a small emergency fund if you have money invested in shares or in collective investment schemes known as unit trusts, in which a group of investors pool their money across a range of investments. My concern is that if you have an emergency you might be forced to sell these investments at a bad time, which is obviously not ideal.

Rule 3: Always spend less than you earn, and try to save at least 15% of your total annual salary or income. Again, the only way you will have the necessary patience and discipline to follow this rule is if you give yourself a goal to work towards. Try to identify what will motivate you to spend less every month and not to buy things or spend unnecessarily. Make your goal relatively small and achievable, so that every time you get the urge to spend, you will think of your goal and hopefully not spend unnecessarily. As you reach your goal, replace it with another small and achievable financial target.

Rule 4: Build your income-generating assets so that they will eventually pay for your expenses in future. This means you won't have to rely on your income from work to cover your expenses.

Many people do try to build up their income-generating assets, but they often forget about rules 1, 2 and 3. These are essential building blocks, however. If you don't ensure that you follow all the rules at the same time, you are likely to land in financial trouble at some point in your life.

We will be looking at these principles in more detail as the book progresses, but they are the basic underpinning of everything that follows. And these rules have served both me and my clients very well. So when you're tempted to stray from the path – and those times will arise, as we're all human – then simply come back to this chapter and read through the rules again.

Building your financial situation to achieve financial freedom is certainly

possible, but it's going to take some work and dedication, on your part, to reach the goal. Let's see what this means for us in various stages of our lives, starting with when we leave school and take our first job.

2

Starting Out

The long-awaited day has finally dawned. You've left school or university and you have your first proper job. It may not be your dream entry into the workplace, but it's a start, and you're on your way to bigger and better things.

Many young people think it's impossible for them to build a meaningful financial portfolio early on in their careers, so in case you need convincing, here's a real-life example of what is possible. My first contact with this client – let's call her Sonia – was an email she sent me when she was 26 years old.

Hi Warren,

My aunt gave me your name and details and recommended that I speak to you. I have never spoken to a financial advisor before, so I'm not sure how it all works. I am currently saving about R9 000 per month and am not sure where I should be putting my money. Currently it is in the bank at 7.8% interest. I also have some shares. I am thinking about buying some more, which may change the amount I am able to save!

I would appreciate either meeting with you or chatting over the phone – which do you prefer?

Thanks and regards,
Sonia

My most recent email from Sonia was in December 2011, when she was 30. She had exceeded the original financial goals that we set together in 2007.

Hi Warren,

I hope you are well and about to take a Christmas break!

I just wanted to let you know that I reached my goal of R1 million by the age of 30! I currently have R1.2 million in my share-trading account and R100 000 in shares. So I am very satisfied.

Do you think I just need to carry on doing what I have been for the next year? I invest roughly R20 000 per month in exchange-traded funds*– some months more than others, and usually between R10k and R15k per fund per time. I feel comfortable doing this, but when do

you think I would need to let someone else manage this money? I think you know my saving habits better than anyone else, hence the request for advice. The downside of having extra money is that you worry about losing it – sometimes irrationally.

Best regards,
Sonia

* Exchange-traded funds (ETFs) trade on the stock market like an ordinary share, but they consist of a range of underlying investments. Most ETFs are based on an index. For example, the oldest ETF in South Africa is the Satrix 40, which tracks the top 40 companies on the Johannesburg Stock Exchange (JSE). The JSE Top 40 is made up of the 40 largest companies on the stock market, but instead of buying each company individually, you buy one ETF that owns them all.

Let me start by telling you that when I first met Sonia, her income after tax was R14 000 per month. Of this amount, she was saving R9 000 every single month. She took the decision when she started working that she would rent a small flat, buy a cheap second-hand car and try to live like she did when she was a student.

When we spoke again after four years, she was still living in the same apartment and was still driving the same car, even though her salary had doubled over the period. She had kept her monthly expenses roughly the same over three years but had spent some money on nice holidays to different places around the world.

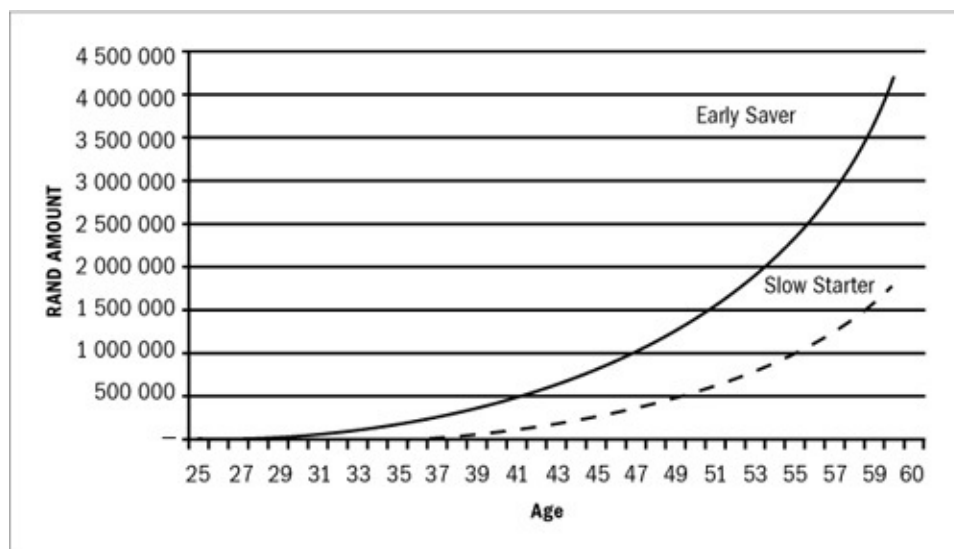
To me, this is a great example of how to save in a disciplined fashion. Sonia set herself goals that enabled her to save a lot of money every month, but she still treated herself to ‘luxuries’ so that she derived some benefits in the short term from her increased salary. After our initial meeting, she only bought exchange-traded funds (ETFs) and did not buy any more shares. This is important because anyone can buy an index; she did not build up her savings because she was great at choosing shares or timing the market.

I estimate that Sonia will be financially free by the time she is 35 years old. She will not stop working at that time, but she is keen to change careers and work with some charities that cannot pay her very well. Knowing Sonia, she will probably live on the income that she earns from the charity and leave her investments untouched so that they can continue to grow. I also explained to Sonia that once her assets exceed R2 million in value, we will need to meet again to determine whether she is still on track.

THE WONDERS OF COMPOUND INTEREST

If you're ready to toss this book aside right now because you have only a couple hundred rand to invest each month instead of R9 000 like Sonia, hold it right there. Even a small amount can grow if you understand how compound interest works. For example, if you put R1 000 a month into an ETF and you increase your investment by 10% every year, you could have R100 000 within six years. It will then take only another 13 years to get to R1 million.

This may seem like a long time, but it's important to remember that your first million is the hardest to create. Once you have your first million, it will take you only another five years to get your next million, and then only three years for your next million. The power of compound interest works most powerfully for you over the longer term, as shown in the graph below.



Starting early pays

The solid line in the graph shows what happens when a person starts saving R1 000 per month at the age of 25 and stops saving when he or she turns 35 (the Early Saver). The dashed line shows another person who starts saving R1 000 per month at age 35 and continues until age 60 (the Slow Starter). Both people invested in the same high-growth balanced unit trust (in which a group of investors pool their money across a range of investments). The Early Saver invested a total of R120 000 over 10 years, while the Slow Starter invested R300 000 over 15 years. By the age of 60, the Early Saver has investments worth

R4.2 million, and the Slow Starter has investments worth R1.8 million. This is a clear illustration of how compounding can work in your favour provided you remain invested over long periods of time.

The golden rule of saving is to *start early and be consistent with your savings*. Sonia took less than four years to get her first million, but anyone who saves consistently can be a millionaire. If you increase your savings every time you get a raise or a bonus, you could easily get there within 10 years.

CAREER ADVICE YOU WERE NEVER GIVEN AT SCHOOL

But back to your career. Before you start eyeing the corner office, there are some things you ought to know – some tricks of the trade, if you like – that will help you forge a successful career. While people achieve success in their careers via different paths, there are some commonalities I've noted in my years as a financial advisor to wealthy people.

When I say 'career', I'm referring to your entire working life, whether you are an employee or a business owner. In no particular order, here are six guidelines to career success. One or two may not suit your interests or career trajectory, but they are all worth bearing in mind as you embark on your career path.

Specialise

A notable characteristic of successful people is their ability to develop a craft of their own. Most people who have had a long and successful career have developed a certain set of skills and expertise that they have honed over a lifetime. Very few generalists retire successfully.

A good example to consider is that of the middle manager in a large corporation. What is the manager's craft? What skills set does this manager have that makes him or her unique and irreplaceable? People working in large corporations often strive to move into management positions, but is this necessarily a wise ambition? While the fancy titles and potentially higher salaries may seem attractive, you need to realise that a manager holds what is essentially a generalist position. And it's very difficult to specialise in something non-specific. How do you hone your craft when you don't have one?

My impression of retirees who worked as general managers (as opposed to specialists) is that they seem dissatisfied with their careers and relieved that they are no longer in the rat race. Many of them struggle to quantify what they have actually accomplished after all those years of work. A better alternative might be

to develop the necessary skills and experience in an area of specialisation that will make you valuable to employers or clients. For example, an experienced engineer is generally more marketable than the general manager who manages the engineering company. Remember, too, that in times of corporate turmoil – for example, when two companies merge or during an economic downturn – it is often the managers who are retrenched first.

But aim to keep a balance. There is as much danger in becoming too specialised, because you can specialise yourself out of a career. Think of all those experts on VHS recorders – what are they doing now that DVD and Blu-ray players are the standard?

Be a revenue generator

As mentioned earlier, in bad times companies rarely get rid of the people who actually bring in the money. As a revenue generator, you have a high degree of control over your own destiny, and to a large extent your income will be determined by what you can produce for your employer.

Revenue generators are usually in sales. This may not be the career that most parents would wish for their children; professions such as law and medicine are generally perceived to be more prestigious. Ironically, however, it is often the salespeople who have the better lifestyle, because sales cannot be done 18 hours a day, and good salespeople earn great incomes. One of my good friends is a short-term insurance broker. In essence, he sells insurance for your car, home or business. He spends limited time in an office and most of his time with people. His wife often jokes that he does not have a real job because he has so much free time. However, he earns a great income, has built a successful business and has many, many happy clients – myself included.

Most of my contemporaries from university were quite dismissive of my friend when he started working immediately after school. But today, the irony is not lost on my ex-university friends that, in comparison to my insurance-broker friend, they often earn less and work longer hours in difficult circumstances. To those who are starting out in their careers, I would recommend that you spend some time learning sales skills, as these are skills that everyone can use over their lifetime.

Leverage yourself – don't sell your time

There are wealthy people who have made fortunes by selling their time. The most obvious examples are lawyers, advocates, medical specialists and accountants, but these careers all share one drawback. The extra hours that they

sold came at a high cost because it meant that other parts of their lives suffered. They sacrificed family time, exercise, social activities and outside interests. By the time these people retire, they are often socially isolated (and frequently divorced) and suffering from poor health. This can't be the kind of success anyone in their right mind would aim for!

This does not mean, of course, that all professionals who charge hourly rates are doomed to live unbalanced, unhappy lives. However, if you are in a position to choose, rather aim for a position that does not involve selling time.

If you can leverage your time successfully, you have the ability to earn an income even when you are not working, which means you can achieve balance between work and the other important aspects of life.

Writers, musicians, actors, asset managers, software developers, financial planners and academics are examples of vocations that are not solely driven by selling time. In contrast, a lawyer who charges an hourly rate for his work is limited in how many hours he can sell to clients. By definition, there are only a fixed number of hours that you can work in a day. This means that even if you increase your hourly rate you will not earn money if you are not billing someone. And the more hours in a day that you sell, the less time you can spend with loved ones.

On the other hand, an asset manager who manages money for people will earn an income irrespective of whether she is working on a particular day or not. As long as she is managing money for people and they remain clients of hers, she will earn an income.

Similarly, a writer of books or software only needs to write the items once. Thereafter the items will be sold and the writer will earn an income repeatedly from the same piece of writing.

Don't work in a job that you hate

By definition, work isn't meant to be 100% fun. If it were fun all the time, it wouldn't be called work. It's not realistic to think you can have a career where you *only* do what you love – no matter how much the self-help gurus might tell you otherwise.

However, this does not mean that you should be doing something you hate. Of course you should be working in a field that interests you, or you won't ever want to get out of bed in the morning and go to work. So be sure to choose something that interests you – if possible, something you're passionate about. While you don't have to love your work 100% of the time to be successful, you are unlikely to be good at it for many years if you loathe it. Remember, you are

likely to spend the bulk of your adult life working. If you hate your job, you are not going to enjoy your life.

I often meet people who dread going to work and only really 'live' when they are not at work. This is a genuinely depressing scenario. It's imperative to find some enjoyment or fulfilment in work, given that we spend so much time doing it.

Don't only aim to get rich – strive for a bigger goal

Of the world's most successful people – such as Steve Jobs, Roger Federer, Warren Buffett, Bill Gates, Richard Branson – very few of them, if any, started out with the sole aim of becoming rich. They all wanted to achieve something special and their resultant wealth was a by-product of their success. For example, Steve Jobs wanted to change the world using computers. At the time he started Apple, the computing world was dominated by large computers that were owned by a few big companies. His vision was to enable every person to buy their own, smaller computer. At the time, this was a radical idea. He succeeded in changing a few industries and along the way became enormously rich.

History is not filled with financial giants whose only objective was to be rich. Chasing money as a primary goal often makes you focus on the wrong objectives and leads to failure. In fact, many of the big corporate frauds, such as those associated with Fidentia, Sharemax and Bernie Madoff, are a result of this kind of short-term thinking. These fraudsters don't start out with the intention of ripping people off – they are simply looking for the quickest way to become rich and take too many short cuts. There's a reason Warren Buffett has never been linked to corporate scams: he has always had a long-term focus that was totally removed from the noise of stock markets. Although he enjoys the limelight, he does not live in fancy houses nor does he drive expensive cars, because he is not materially motivated. His wealth is a by-product of his focus on building a great company that owns other great businesses.

Perseverance creates luck

Many successful people claim that luck had a role to play in their accomplishments. There may be some truth in this, but luck alone is not enough. They had to keep working, without giving up, in order to benefit when their good fortune presented itself. Never forget the famous quote often attributed to golfer Gary Player: 'The harder I practise, the luckier I get.'

To use another sporting example, the best Test cricket batsmen cannot make big scores if they are sitting in the stands. The only way that they can remain

batting at the crease is if they are willing to persevere when things are not going their way. The history of cricket is filled with many talented individuals who never achieved much because they did not buckle down when things got tough. With business and investing it is exactly the same. It is not good enough to be highly intelligent and to have good ideas; you have to be willing to do the hard work for hours on end, day after day.

I believe that one of the biggest differences between an achiever and a failure is that the achiever carries on practising and working when the failure has already gone home or to the pub.

CASH IS KING

When you get that first payslip and salary cheque, the temptation is to go out and spend it. Media mogul Oprah Winfrey often recounts the story of how she blew her first salary cheque on towels, because she'd never had nice towels before!

And then all of the store accounts beckon. As soon as you have a regular income, credit mongers start coming out of the woodwork, and it's hard to resist the lure of those shoes you just have to have, or the really swish watch you've been eyeing for some time.

The best advice for when you start working is to *avoid all debt as far as possible*. As a starting point, try to build up some cash reserves of at least three months', but preferably six months', worth of whatever your living costs are. This is your safety net in case of unforeseen events. Invest it in a money market account that pays high interest but can be accessed within 24 hours.

Once you have this cash safety net, try to *invest 15% or more of your total monthly salary into a long-term investment*. This means that if you are earning R5 000 a month before tax and deductions, you should be investing R750 a month. You should invest this amount every month and never use it for normal expenses or for extras such as holidays, clothes, cars or furniture. Instead, save separately for those items and *never* use debt to buy something that can disappear or lose all its value. Things like clothes, appliances and furniture should be bought with cash. If you can't afford to buy these items with cash, then you cannot afford them.

DEBT

Debt – the state of owing money – is the biggest trap for wealth, and most of the world's savvy investors have avoided debt at all costs. There's a major lesson to learn here: debt kills people ... literally. It is a major cause of suicide, divorce and unhappiness in relationships. And while it can be a valuable financial tool, I think it should be offered to people only in very rare circumstances.

When you are young, try at all costs to avoid debt, especially short-term debt as described below. I know it's hard *not* to buy clothes, TVs and furniture when you are starting out, but debt is not the way to buy these items. Rather save for a few months and buy one big item at a time.

There are three main types of debt most commonly incurred by young (and older!) people:

- *Short-term debt* includes credit card and store card debt, personal loans and hire-purchase agreements. Such short-term debt can only be described as bad debt and should be avoided – always.
- *Medium-term debt* includes loans for vehicles financed over 54 to 60 months. You can use debt to buy a car, but be careful and do your homework. Many people spend too much on cars. You should not spend more than 20% of your monthly salary repaying car debt. And don't forget to factor in maintenance costs, petrol and insurance – these are part of your vehicle costs.
- *Long-term debt* includes home loans. This can be good debt because you are incurring debt to purchase something that could appreciate in value. Most people will take a loan from a bank to buy a home and then aim to pay off that loan over 20 years or less. In an ideal scenario, the home will appreciate in value so that it maintains its worth against inflation. This means that you can sell the home one day and get real value for the asset. However, you should try to ensure that your debt repayments are small enough so that you can pay all the running expenses of the property and still save money.

As you can see, there are times when you can use debt, but you need to be careful and treat it as a necessary evil rather than a way to live a better lifestyle. If you can't afford to buy nice things without debt, then you can't afford them. Those who live without debt early in their careers are always in a better financial position than their contemporaries who live with debt.

PLANNING: THE KEY TO WEALTH

LEARNING THE TRICKS TO WEALTH

It's worth saying again, just in case you don't already know this: the earlier you start saving, the better for your long-term wealth. But there are also enormous advantages to planning *how* you save and spend your money.

A report by UBS Wealth Management in Switzerland highlights the difference in wealth of people who are good planners versus those who are bad planners. It shows that if you don't budget and don't have investment and retirement plans, you are guaranteeing that you will limit your wealth over your lifetime. The report also shows that even a small amount of planning can make a massive difference.

Budgeting

There's no avoiding it: you need to budget. Too many people get to the week before payday wondering where their money went. By the time they get to retirement age, they'll be wondering why they have no real savings.

If you find yourself in this position on a monthly basis, it is almost certain that you don't have a budget. And if you need help in setting up and managing a budget, there are a range of useful budgeting tools available on the internet, where you can get your monthly costs itemised and categorised automatically by allowing the tool to access your banking information. You'll find some of the more useful tools on these websites:

- www.22seven.co.za
- www.mint.com
- www.bullseye.co.za
- <https://MyFinancialLife.nedsecure.co.za> (provided by Nedbank)

A good budget should be very simple and, more importantly, realistic. Don't start with what you *should* spend. Rather start with what you *actually* spend. For example, if you currently spend R5 000 per month on food, restaurants and entertainment, there is little point in budgeting an amount of only R2 000 from next month. Rather start by reducing these budgeted costs by R500 a month and see if you can stick to it. This will help you to progressively decrease your costs over time to a level that is realistic and which doesn't reduce you to the life of a home-bound hermit. And this principle should apply to all your variable expenses (costs that vary from month to month), as some expenses, such as your rent or mortgage, are not variable (these costs stay the same over time).

In addition, you should start budgeting to save some money every month. Your company pension on its own will not be enough to live on when you retire, so you will need additional savings. You should try to save 15% of your gross

salary every month. In other words, if you earn R10 000 per month before deductions, then you need to save R1 500 per month. If this is too much, then start at a lower percentage (say, 8% or 12%) and progressively increase your savings over time as you get salary increases.

Planning your savings/investments

There's a simple principle at play when it comes to saving and investing: the more you plan your finances, the greater your chances of being wealthy.

Your plans don't need to be complicated either. If you start with a simple budget and stick to it, you will eventually get to the point where you are building up savings. You can use these savings to build your cash safety net. Once your emergency fund is established, you can then start your investment planning.

Like your budget, your investment plan can be very simple, such as a monthly investment into an ETF, shares or RSA Retail Bonds (these bonds are low-risk investments that pay a fixed rate of interest for a fixed time period, with your money and the interest guaranteed by the government. You can refer to [Chapter 9](#), 'Investment Options', for more information on these investments.) Or if you have the inclination, you can start researching investments in more detail and create your own portfolio of investments. If initially you don't want to manage investments on your own, make use of unit trusts or contact a professional advisor.

WHERE TO INVEST YOUR MONEY

Once you have some money to invest, deciding on an investment option can be a bit intimidating. After all, there are so many opportunities to lose money or get ripped off, as well as a wide array of good choices – how do you pick one? The good news is that there are some easy-to-understand investment options that are low cost and will generate good growth. You just need some common sense and patience.

Before choosing an investment, you should set your investment goals. These are usually time-linked in months (e.g. saving for a holiday) or years (e.g. saving for a house). The length of time will determine what type of investment you should make.

Short-term goals: one month to three years

If you have a goal that needs to be achieved within a period of three years, you should not be taking investment risks. Rather invest your cash in a money market or fixed-deposit account at a bank, as these are relatively safe investments when provided by financial institutions such as banks and credit unions. Make sure you ask lots of questions before signing any forms to start an investment at a bank. Some banks will get you to speak to a consultant or advisor who will try to steer you into buying a unit trust or other product where they charge upfront commission. With cash investments, you should be especially cost conscious, as fees will eat into your returns. Don't make any investment where the bank charges fees for opening or adding to a money market account.

Most of the banks offer instant-access money market accounts for which no fees are charged and which pay relatively high interest. Generally you will earn higher interest on bigger amounts and on amounts that are invested with the bank for longer periods. This means you will earn more on a six-month fixed deposit than on a 32-day notice account. Be sure to shop around and don't blindly follow the advice of the 'consultant' at the bank, because they earn commission on selling the investment product and are not paid to look after your best interests.

You can also invest in a money market unit trust offered by an investment advisor, but again make sure that you do not pay upfront fees. It is acceptable for an advisor to earn an annual fee from your unit trust (no more than 0.5% per year on money market unit trusts), but only if the interest you earn after costs on

the unit trust is better than the rate offered by the bank.

Longer-term goals: three years or more

If you are planning for a long-term goal, you should be prepared to take some investment risk. That means you should look at investing in shares instead of cash. A share is the smallest unit of ownership in a company or unit trust. You can own shares in private companies as well as in companies that trade on the stock market. Shares will give you three or four times more growth than cash, but shares are more risky, which is why you need to invest this money for longer periods of time.

There are many ways to invest in shares: you can buy them directly through a stockbroker, via an ETF, or through unit trusts, endowments or even retirement annuities. In an endowment, you invest your money for a minimum of five years or longer. The money that you take out of the endowment when it matures is tax-free. A retirement annuity is basically a personal pension fund. Essentially, you put away a certain amount of money each month, and when the fund matures at retirement age, it will pay you out either a lump sum, a monthly pension or a combination of the two. (See [Chapter 9](#) for more on these investment options.)

With smaller amounts of money, the cheapest and easiest way to invest in shares is through an ETF. An ETF trades on the stock market like an ordinary share, but it consists of a basket of shares in various companies. Essentially, an ETF allows you to make one investment in which you buy many underlying shares. You can invest on a monthly basis with a minimum of R300 per month or with a R1 000 lump sum. The only real downside is that you are charged an annual fee of up to 1% when you opt for monthly investments, but this is still low compared to fees for most share-based unit trusts.

You could also buy individual shares directly through a stockbroker to build your own portfolio. This would mean that you would actually own shares in particular companies of your choice. For people who are new to share investing, I generally recommend that they invest in large, well-known businesses that have been in existence for many years. It always makes sense to use your own knowledge of businesses when buying shares. For example, if you are an engineer, you might have a good insight into the building industry, so you might consider construction shares first. This would require some research on your part, as you need to be very sure of what you are buying. Individual shares can generate great returns but can also lose you loads of money if you choose badly. You should aim to buy shares in minimum lump sums of R30 000. Because you will need to purchase shares in at least eight different companies to have a

properly diversified share portfolio, you will require R240 000 to start your own portfolio.

You can also access shares through unit trusts. Unit trusts are also known as collective investment schemes (CIS) or mutual funds. They are open-ended investments (i.e. they have no set limit, either in time or money) that are operated by an investment company. Each investor in the unit trust is called a unit holder, and they are the only owners of the unit trust. There are many types of unit trusts, as they represent a variety of investments, including shares, cash, bonds and property. It is important to understand that a unit trust is not the same as shares. It is merely a way for many investors to pool their money to lower costs.

Unit trusts are well regulated, so you can rely on the information supplied in the marketing material – often called fact sheets. The fact sheet explains the risks, costs and returns of the unit trust. Try to invest in funds that have a track record of at least five years or more – don't simply pick the best-performing unit trust of the moment, because the top fund today could easily be the worst fund in six months' time. Look for a fund that has generated consistent growth and has generated more growth than the JSE All Share Index over five years or more. (The JSE All Share Index is normally quoted as a number – *e.g.* 'The All Share Index reached 37 213 today'. This is simply a 'value' of all the shares on the stock market and is meaningful only in that it explains whether the whole stock market has gone up or down over a specific period. However, it is a useful way to measure whether a specific investment has generated good growth over long periods of time.) There are not many unit-trust funds that have beaten the All Share Index, so do your homework. And again, be wary of costs. You should not pay upfront fees and you should pay annual fees of no more than 1.5% to 2.3% per year.

If you follow the investment principles set out above, you will be a very effective saver. People often try to create a sense of mystique about the investment business, but it's not complicated at all – it's difficult. And it's difficult only because most people are incapable of spending less than they earn and don't like to wait for five years to achieve a goal – they want instant gratification.

With investments, time and patience are your biggest allies and short-term thinking is your greatest enemy.

Other longer-term investment options

Retirement annuities (RAs) are the insurance salesman's best friend. He or she

can earn a good commission from a relatively small monthly investment while you end up paying off the commission over a few years before you actually benefit.

Of course, this doesn't mean all RAs are bad investments. You can invest in unit-trust-based RAs that charge only pay-as-you-go fees (that is, no upfront commissions). And an RA is a good investment if you are working in a company that does not have a retirement fund or where you earn commission or large bonuses.

If you earn only a monthly salary, however, you may not get much benefit from an RA. The general guideline is that you can get a tax benefit if you invest up to 15% (to be increased to 27.5% of your income in 2015) from bonuses, commission or a salary into an RA if you do not have a company retirement fund. Be sure to check this calculation with a tax specialist or professional investment advisor before investing in an RA.

Finally, it is important to know that you cannot access your RA until you are at least 55 years old, so be careful. When you access the money from your RA, you will be taxed on the money that is paid out to you. There are some tax-free amounts that you can earn from the lump sum from your RA, but most of the money that you will be paid will be treated as a salary and taxed accordingly. Make sure that you do your homework before taking money out of your RA because the taxes change annually. In general, keep in mind that RAs can be great investments, but you need to be sure of what you are getting into.

Endowments can also be good investments, especially if you want to invest for five years or longer, as the proceeds from your endowment will be free of tax if you hold the investment for at least five years. (This is because the endowment itself pays income tax and capital gains tax.) Be sure to invest only in unit-trust-based endowments and pay fees on a pay-as-you-go basis, as upfront fees and commission can wipe out growth. Whatever you do, don't commit to an endowment with a term longer than five years. You can always extend it later.

In general, try not to invest in traditional insurance-based investments. Unit-trust-based investments are more transparent and flexible.

Property: buy or rent?

We are all told that it's a good idea to own your home rather than rent one, and intuitively it seems more sensible to pay off your own bond rather than your landlord's. But tread cautiously here – very often, it makes real financial sense to rent a home for a few years while you save money to buy one.

Since the 1960s, shares have grown in value more than three times faster than

home prices. If you judge the two as investments only, it makes sense to invest all your money in shares and not in property, but as conventional wisdom has it, 'You cannot live in shares', so we can't make this decision on investment performance alone.

Most studies on property ownership show that in most instances it is better to rent a home instead of buying one. For example, in Johannesburg at the time of writing, you can rent a R1.1 million apartment in Athol for R8 000 per month plus electricity. If you were to buy the same apartment, it would cost you R10 982.18 in bond repayments (at current interest rates) plus another R1 100 in levies and rates. This means it costs you R4 082.18 more per month to own your home than to rent the same property. Financially, it makes more sense to rent the apartment and invest the R4 082.18 difference in the stock market for the next 10 years. It is likely that you will be able to buy the apartment with cash (or a small bond) in year 10. From that point onwards, you can keep saving the R4 082.18 to create additional investment capital.

There are other important factors to consider too. For example, owning a home means maintenance and insurance costs you don't have when you rent, and you will have to pay transfer and bond registration costs when you buy the property. In addition, you will have to pay an estate agent a commission of 5% to 7% of the value of your home when you sell it.

Unfortunately, most people are not good at saving their money. It is far too easy to sell investments to buy a new car or a widescreen TV or to blow the money on a dream holiday. So, if you're not a disciplined saver, it might make sense to buy a home. Hopefully the fear of losing your home will be enough to force you to pay your mortgage every month.

HOW TO GET RICH AS AN EMPLOYEE

You don't have to own your own business if you want to be rich. You can work for a boss and still become wealthy. If you want to have the safety net of a monthly salary but are prepared to take some risks to make money, you can become a tycoon in your own right. You just need to treat your salary and your savings in a new way and be prepared to take some risks in the same way that an entrepreneur does.

Here's an example below of a how a salaried person (let's call him Schalk) can generate R3 million in less than 20 years.

The first million takes the longest

Let's say Schalk starts work as a debt-free graduate at age 23 and takes home R15 000 per month. If we assume his monthly expenses are R10 000, he will have R5 000 to invest every month.

As a starting point, he should build up some cash reserves of R60 000 (that is, six months' worth of living costs). This is his safety net in case of unforeseen emergencies, and it should be invested in a money market account that pays relatively high interest but can be accessed within 24 hours. It will take Schalk twelve months to raise this amount.

Once that's done, he can start investing his R5 000 in shares via an ETF. We project that this will grow at an average rate of 15% per year, or per annum as the financial world puts it, over his lifetime. There will be years when he will get a lot more growth and other years when his shares will go down, but 15% per annum is a realistic average. If Schalk invests every month in an ETF with an average growth rate of 15% per annum, he should have R300 000 within three years and nine months. At this time he will need to take his biggest risk and borrow R150 000 from the bank to buy more shares. Typically, banks are prepared to lend you 50% against the value of your shares provided you cede the shares to the bank as surety.

Of course, it is considered a high-risk strategy to borrow money to invest in shares, so this is not a strategy that I would recommend for all investors. However, if you are prepared to take additional risks in the pursuit of wealth, this is one strategy that you can follow. It would be a similar strategy to what an entrepreneur would follow if he were to borrow money to start a business. I would recommend this strategy only if you invest in a diversified portfolio of shares or ETFs and only if you have the risk appetite to deal with the difficult times on stock markets. It is also important to take a long-term view of your share investments: they will rise and fall frequently over a 10-year period, but they will reward your patience.

It will cost Schalk R3 891.08 per month (according to a large bank's personal loans calculator) to repay the R150 000 loan over five years. In the interim he will use the R150 000 to buy more shares, which means he now has a total of R450 000 invested. At 15% growth compounded per annum, he will have R905 110 within five years – provided he keeps investing the R5 000 per month in debt repayment and savings.

This means that Schalk should have R905 110 invested in shares by the time he is 35 years old and he will be debt free. Schalk will also have a sizable amount of cash in the bank from his R60 000 safety net that he started when he was 23.

Now the fun really starts

Once he has his first million, Schalk will be able to generate his next R1 million within four years, or by the time he is 39 years old. It will take an additional three years for him to generate his next million. By the time he is 42, he will have R3 million invested. If Schalk is brave, he can speed up this process by borrowing every five years and investing this money in shares.

Alternatively, he can increase his savings as he gets salary increases or bonuses. The hardest part of this whole exercise is raising the initial capital. Note that it will take only 15 months for R5 million to increase to R6 million.

Is this example realistic?

It is definitely possible to become a millionaire within 10 years, but it is not usually wise to borrow money to invest. Borrowing money to invest in shares is relatively risky, but perhaps not more risky than investing in a rental property. You certainly won't need to worry about tenants not paying rent or destroying your property, but you will have loads of stock-market fluctuations. If you can live with these fluctuations and you can afford interest-rate increases, you can make real wealth.

It is also possible to invest R5 000 per month as a salary earner if you have a reasonable job. You will certainly be tempted to spend money on cars, houses and holidays, but if you can delay your spending for eight years, you can get a great head start. My calculations assume that you only ever invest R5 000 per month – I have not assumed that you increase your savings as your salary increases. This means that you can use your increases to buy cars and houses, but you should always try to invest the R5 000 per month.

Naturally many people will struggle to limit their lifestyle costs – it is human nature to want to spend all your money every month. If you really want to get wealthy, you will need to sacrifice your short-term comfort in favour of long-term wealth. If you are prepared to make these sacrifices, you are certain to be richer than most of your friends and neighbours!

Now it's time to get to grips with some of these concepts in more detail, as we consider the 'mid-career' stage of life.

3

Building Up and Balancing Out

When we move into the middle phase of our life – and typically this means the married-with-children stage – our earnings start to increase substantially, and so do our lifestyle costs. Most people in this phase are aged 30 to 50, and as our families grow, we find we need a bigger house and a bigger car, and then there are the school and university fees. A good education can be very expensive.

This is also the stage of life where your financial planning can be derailed unless you maintain tight control of your budget and investments. It's not just about you and your money any more. There are many other demands on your finances, as well as other people to consider.

In my experience, most people who are in a bad financial position later in life find themselves where they are because they allowed their expenses to spiral out of control as they tried to provide for their families. This is why I call this stage of life the balancing act.

PRIORITISE YOUR FAMILY GOALS

Achieving balance in your financial life is incredibly challenging when you have children. Your urge as a parent to provide the best for your offspring makes it hard to spend less on your children in an effort to maintain your retirement savings and financial well-being.

I find conversations about this with parents, especially those with young children, quite difficult. The primal need to provide for one's offspring overrides everything else and it is often tough to have rational discussions about money and children. This applies equally to men and women, and those who are financially astute are not immune.

Now don't get me wrong – I'm not saying it's bad to want to provide the best for your children. The flip side of this, however, is that it often becomes counterproductive. As you spend more than you can afford, so you dig a deeper hole for your family, which can create unbearable financial stress. And many families simply never recover from that.

One of the major causes for divorce is financial stress, and most often children

are the real victims. While this might seem overly gloomy on my part, it is a reality that I have seen unfold many times over the last couple of decades. So, to protect yourself and your family from this situation, it is important to agree as a family what your priorities are and how they will be funded.

Many parents want their children to go to a private school. But you need to do your homework – and your sums – very carefully before you commit to this financially. Private-school fees are very expensive, and they escalate yearly. The question is, is private schooling really affordable, given your household income and the number of children you have? Are you prepared to make sacrifices elsewhere? Sending your children to private school might mean you need to live in a smaller house, possibly in a less expensive neighbourhood, and drive a cheaper car. All of this must be taken into account.

When I have conversations along these lines with parents of younger children, they are often not prepared to compromise on anything where their children are concerned. This means that they sacrifice their long-term savings and often take on more debt than they can afford. The result of these decisions is that these parents, at around age 50, are often left with limited savings, a large mortgage and a bleak financial future.

This is a situation that can be prevented by setting realistic priorities for your family and being disciplined enough to stick to them. The best way to do this is for parents to put their priorities in writing once they have agreed what they are and to revisit them regularly.

PLAN AHEAD

If you have decided to have children, it's a good idea to prepare your physical and financial situation early on, even before the baby is conceived. For example, if you need a bigger home in order to raise your family, then make the move before the time and ensure that your home is as you need it to be before the baby is even on the way.

Also ensure that you have sufficient emergency funds available to cover unforeseen medical expenses and other costs. Medical aids don't cover the full costs either during or after pregnancy. Talk to other parents to find out what it costs every month to feed, clothe and care for a child, and plan the number of children you will have accordingly. I estimate that it will cost more than R1 million to raise a middle-class child in South Africa if private schooling is required.

You also need to plan for catastrophe: who will look after your children if both parents die? This means you need a will, and you might need life assurance

to provide the guardians with funds to cover the unexpected financial burden.

People are often tempted to ask their parents to be guardians of their young children, but this is not necessarily the best solution. Elderly people are often not well suited as guardians of teenagers. A close family friend or sibling might be a better option. Choose that person or couple carefully, and be sure you ask their permission before you make them guardians, as some people might feel uncomfortable with the potential responsibility of caring for your children.

SAVING FOR EDUCATION

If you feel that education for your children is important, you should try to start saving for it as early as possible, ideally once your child is conceived. If you're planning to have a family sometime in the future, there's no harm in starting an education fund before conception. Once again, compound interest can be a wonderful ally if you start saving early.

Banks and life assurance companies like to sell 'education plans', which are simply endowments that are packaged by marketing people. While I think endowments have a role in financial planning, they are typically better investments for high-income earners who are at the maximum tax rate. A potentially better option is to look at Fundisa, an investment created by the government, the Association for Savings and Investment SA (ASISA) and a selection of financial companies. Fundisa (www.asisa.co.za/fundisa/) is designed to help people save for a child's tertiary education, and it's a good alternative for people who can afford to save only small amounts – the minimum starts at R40 per month.

The government will top up your contributions to this scheme by adding 25% to the amount saved annually, but only to a maximum of R600 per year. The annual cost is reasonable at 1.25% + VAT of the value of the fund per year, and given the low minimum investment requirements, Fundisa should certainly be considered by those who are able to save only small amounts.

It is important to note, however, that the money in a Fundisa investment can be used only for approved tertiary institutions. In addition, the underlying investment is a low-risk unit trust that pays interest. This means there is no money invested in shares, so the growth will be quite low over the long term. Still, in my view there is nothing better available if you are investing less than R300 per month, and Fundisa is certainly better than an education plan.

For a young family, however, I prefer a monthly contribution to a unit trust or ETF. There is a wide range of unit trusts and ETFs to choose from. If you are going to make this type of investment, try to invest in something that has a high

allocation to shares and property companies, because these are productive assets that will generate the best growth over the long term. In addition, make sure that you are not charged any upfront fees or commissions, and that the total annual costs (fund and advisor cost) are less than 2% per year of the value of your fund.

Most ETFs will accept monthly minimum debit orders of R300, so there is really no excuse for people not to start saving immediately. And you can buy your ETF either directly from the provider or via a stockbroking account. For smaller monthly investments, I prefer going directly to the provider, as your transaction costs will likely be lower. If you are going to invest large lump sums rather than monthly debit orders, purchasing an ETF from a stockbroker might be preferable, as your costs are likely to be lower. (ETFs and unit trusts are discussed in more detail in [Chapter 9](#).)

I often recommend to parents that they tell their relatives and friends about the investment, as they can make gifts to the investment rather than buy the children presents. This works particularly well for very young children. My wife and I tend to make these gifts to all our friends' children, and when the children are a bit older, we buy them something small and continue to place money in their investment account.

MANAGE DIFFERENT PRIORITIES IN PARALLEL

Once you have established your priorities for your family, try to reduce them to an actual targeted amount of money per goal. This will help you in setting your budget and enable you to gauge your progress in meeting your priorities and to take action as early as possible if you stray off target.

For example, you might calculate that schooling will cost R600 000 for 12 years at a good government school, and you will need another R300 000 for three years of tertiary education. You should start saving for these goals as soon as possible. You should also review those savings annually, to check whether your targets are still accurate and to gauge whether you will achieve your goals on time. Schools often provide substantial discounts if you pay your fees for the whole year in advance, so it becomes very beneficial to have funds allocated in advance for schooling.

INCOME GROWTH MUST EXCEED YOUR GROWTH IN EXPENSES

It is human nature to allow your expenses to escalate as your income grows.

There is nothing wrong with this, provided your income and savings increase faster than your expenses. You need to increase your savings over your lifetime, and this means that you have to plan to save a portion of all your salary increases so that you don't become accustomed to spending all of the increased income.

Most people will have debt at this stage of life, and I recommend that salary increases be used to pay off debt more quickly. Many people use their annual bonus to put large lump-sum payments into cancelling or reducing debts.

You should aim to be debt free by the time you are 50 years old. This will enable you to focus on saving and investing for retirement. If you still have a mortgage at retirement age, you are probably in deep financial trouble. And remember that putting just a small amount into your mortgage every month, over and above the minimum payment, can have a significant impact on reducing the total cost of your mortgage over your lifetime. The table below shows how much you could save if you were to buy a property for R1 million and you paid off a bit more than the minimum required monthly payment.

Extra monthly payment	Length of repayment	Interest savings
R100		

19.37 years	R49 780
R500	

17.28 years	R211 374
R1 000	

15.32 years	R357 491
R2 000	

12.62 years	R550 403
R5 000	

8.46 years	R825 991
-------------------	----------

INVESTMENTS SHOULD STILL BE HEAVILY WEIGHTED IN SHARES

If you are 45 years old and plan to retire when you are 65, you still have 20 years of saving ahead of you. This is a long period of time, which means you can maintain a high portion of your investments in shares. Shares are one of the few investments that will beat inflation over a long period of time. The 20-year time frame is important because shares are very volatile investments, which means you need to remain invested for long periods of time to be sure that you do not experience a loss. Remember that you might live until age 85 or even longer, so your assets need to last for at least 20 years after retirement.

Because the best investment for growth is the share market, shares should comprise the bulk of your investments. Many retirement advisors recommend that as people get closer to retirement, they move their investments into cash (e.g. money market accounts and fixed deposits) so that they don't experience a loss if the stock market crashes shortly before they retire. However, while an event like that would be very stressful, keeping a large amount of your retirement savings in cash is only going to guarantee that your capital loses pace with inflation.

The wiser approach is to ensure that your retirement savings are well diversified and that you have sufficient capital to see you through a market crash. It is almost inevitable that you will experience a few market crashes between the ages of 45 and 85. However, if you have diversified assets, any market crashes are likely to be less stressful. More importantly, a diversified asset base that includes shares is likely to grow very nicely over your lifetime so that you can lead a comfortable retirement. In the next chapter we will look at how best to structure your assets so that you can make the most of your retirement years.

4

Retirement

There's a good chance that you will live as a retiree for longer than retirees of the previous generation, for a number of reasons. Not only are we living longer, but companies are also encouraging employees to retire earlier. And this means that in the near future we could be retired for an average of 40 years. For many people, this will mean being retired for longer than – or at least for as long as – they spent working.

Consider some of the statistics. In 1900 people in the US lived to an average age of 47, and in 2000 the average age was 77. In Japan, the current average lifespan is 81 years, so 90 cannot be far off. The fact that people are living longer, healthier lives is a reflection of advancement in our society. Fewer people are dying from disease and starvation, and improvements in health care have enabled people to live better-quality lives.

Ironically, however, the advances we've made that have led to better, longer lives for all could lead to economic difficulties in future. If the majority of the population is elderly and retired, there are fewer people to do the work to drive the economy. And on a practical level, there are fewer people to physically care for the infirm.

But in our era, 60 really has become the new 40, with many more people remaining active and productive well into their 70s. We will easily be able to function in the modern workplace for an additional 20 years should we choose to do so.

On the flip side, however, employers have a different objective, and encourage people to retire early. Most employers view older people as more expensive, and because they have more years of service, they also cost more to retrench in bad economic times. This is not something I agree with, because the experience of older workers and their maturity means that you get back great productivity for the money you spend on them. Nevertheless, the truth is that employers encourage people to retire at age 60, or 65, in most cases.

This combination of increased longevity and early retirement will have a significant impact on our lives. We could be retired for 30 to 40 years – which may be more time than we spent in our formal careers!

If it's true that 'time is money', then people who retire at age 55 and are able to work for another 15 to 20 years have a tremendous asset. Many people in their 50s and 60s, and even their 70s, are still energetic and have a wealth of expertise and experience to offer. It's the dawning of the age of the non-retired retirees.

TURNING RETIREMENT THINKING ON ITS HEAD

Realistically, to be retired for 30 years can be problematic. First, 30 years is a long time to keep busy. Second, the prospect of funding yourself for 30 to 40 years without earning anything is difficult unless you are very wealthy – which doesn't describe the majority of people. But if you can aim to be financially independent by the time you retire, you have two factors in your favour: (1) limited financial pressure and (2) experience. Armed with these two factors, you can approach retirement as an opportunity to embark on the career you have always wanted.

What is financial independence?

I can't give you a figure and say if you have that much money invested you will be financially independent. But there are four basic hallmarks that apply to anyone who is financially free. Don't get me wrong – financial independence is not an easy goal to reach. But if you've managed your money well, each of the following should be true. How many apply to you?

1. You are free of bad debt, which is debt incurred to buy things that will be consumed or will not appreciate in value over time.
2. You have an emergency fund equivalent to half your annual expenses that is saved in a money market or 30-day notice account.
3. You spend less than you earn.
4. Your income-generating assets are sufficient to pay for your future expenses.

Financial freedom is not the same as wealth. Some people are financially free with R5 million, while others have assets of R50 million but are still economic slaves. There are people who have retired with small amounts (less than R5 million in investment assets) who are living very well as retirees because they control their expenses and live within their means.

If you have enough retirement capital invested, it will free you up to 'spend' one of your biggest assets – that is, *time* – preparing for your new career without any immediate financial pressure. And any income you earn in retirement then becomes an added bonus, especially when you are starting out.

Your willingness to learn what is required in a new job and your low initial cost to a company should make you an attractive employee, especially to smaller companies in need of good people. Chances are you can structure your position to suit your new life (negotiate more leave for longer holidays, and so on). And people who enjoy their work are often very successful, especially if they are not under significant financial pressure.

Alternatively you can start your own business without the immediate pressure of having to put food on the table. If you decide on this path, it's important that you don't risk too much of your precious financial capital on a venture that might fail. Rather invest more of your other assets – time and experience – in your new business.

Either way, if you start planning your retirement career early, you may find that this becomes the most enjoyable and profitable phase of your life.

HOW MUCH YOU SHOULD BE SAVING

The question I'm asked most often is how much one should be saving in order to retire with enough money. The answer is not as simple as you might think. You

need to take into account global economic conditions, the impact of inflation, and your own expenses and lifestyle in retirement. Moreover, a recent study which we'll be looking at shortly is challenging the conventional wisdom that rules much of the thinking about retirement planning in South Africa. Sadly, many people (financial advisors included) will ignore the findings of this study, resulting in long-term financial hardship. What makes it worse is that a small dose of financial discipline at an early stage can make all the difference.

Understanding the impact of economic and market conditions

At the time of writing, the world's economy is still under enormous pressure, and I think it's safe to assume that it will undergo a long, slow recovery that could take years. If the global economy moves at a snail's pace for the next few years, this will have a major impact on the growth rate of all assets, including shares and property.

One of the problems with retirement planning is that you need to make assumptions about how much capital growth you will need every year for the remainder of your life. The best capital-growth assets are shares and commercial property. Over the very long term, shares and commercial property have grown by 11% to 15% per year, but there have been long periods where this growth has been much less.

At present we could be experiencing one of those periods in which shares grow by only 6% to 10% per year for the next few years. For retirees or those close to retirement, this could be a major concern because it means their capital might not keep pace with inflation, or even their monthly expenses. We all need to be aware of this because if we make changes now, we might prevent years of hardship later.

Inflation and your investments

In South Africa, there's a strong link between interest rates and inflation, because the Reserve Bank uses interest rates to control inflation. So, when inflation increases, interest rates also rise, and they are maintained or reduced if inflation is under control.

If you are in debt, you are generally hoping for low inflation, because it means low interest rates. On the other hand, retirees often rejoice when interest rates go up, because they feel that they are getting a better return on their money. But you need to see the bigger picture: increased interest rates mean inflation is also high, so there's no real benefit.

Simply put, if you put R100 in the bank today, you might have R110 in

10 years' time thanks to high interest rates, but that amount will probably buy you only R70 worth of goods in today's terms, even though you haven't lost a cent of your original investment.

Save even more

When younger people start saving, they often want to know how much they should save for retirement. Most people, following conventional wisdom, would tell them that they should save 10% of their gross salary every month. So, if they earn R5 000 per month before deductions, they should save R500 every month. This was the advice given to me when I started working. It was based on a well-known book about saving called *The Richest Man in Babylon* by George Samuel Clason.

I had often given this advice to young family members and staff until I read a more recent study, *Towards a Sustainable Retirement Plan* by Daniel R. Wessels. This study shows that you will need to save 16% of your total salary every month to be certain that you retire comfortably. So, if you earn R5 000 per month, you will need to save R800 per month, which is a much higher percentage than most people currently save. I maintain that a savings rate of 15% will be sufficient in most circumstances, and the difference between my 15% and Wessels' 16% is minimal.

Although 15% is a big chunk of your income to put away, this does not change the fact that we should all aim to save this percentage – the fact that it's difficult doesn't change the reality of what we need to do. We are all living longer and we need to make sure that our capital lasts.

So how much capital do you need?

There are a few ways to work out if you have sufficient capital to retire. Many advisors use a multiple of your final salary. For example, if you earn R120 000 per annum in the last year before retirement, you need $14 \times R120\ 000 = R1.68$ million, which will pay out R98 000 per year.

I prefer to use your actual monthly expenses as a basis for determining how much capital you need at retirement. If you need R10 000 per month after tax, you should multiply this by 12 to get an annual amount (R120 000). Then multiply this amount by 20: $R120\ 000 \times 20 = R2.4$ million. This will allow you to draw R10 000 per month from your capital every month and to increase this with inflation every year for the remainder of your life.

This is quite a conservative calculation, but the study by Wessels shows that even this might not be enough. His findings indicate that you will need

R2.664 million to be certain that you have sufficient capital in all market conditions.

You might need to spend less

Wessels's study also shows that conventional thinking about how much you can safely draw from your capital might be wrong in many instances. Many advisors will tell you that it is okay to draw up to 12% per year from your retirement capital. This was certainly possible in times when the market was growing strongly, but it would be financial suicide now.

If you want to be certain that your capital will last in all market conditions for 30 years or more, you should draw only 4.5% from your capital per year. For people who are close to retirement, this could be horrifying news because it means that you will either need to work longer or spend less if you want to be financially secure.

What are your options?

In general, people are living much longer than previous generations, but their retirement planning has not kept pace with this reality. In addition, investment assets might not grow at the same rate as they did in the past. So, I believe that you should always be pessimistic in your retirement planning. Approach retirement by trying to plan for the worst and then be positively surprised.

For those who are saving for retirement, try to save 15% of your gross income so that you will be very certain you have enough money at retirement. For those who are close to retirement, try to work a few years longer than planned or try to get some part-time work to supplement your retirement capital.

For those who are already retired and have little chance of generating income, you need to reduce your expenses and ensure that your remaining investments are correctly structured. This means you should balance the requirement to generate as much growth as possible with the need to manage your risks, so that your remaining capital is protected from major stock-market losses. The worst thing you can do now is put your head in the sand and hope for things to get better.

INVESTING FOR INCOME AT RETIREMENT

Retirement annuities

We've touched upon retirement annuities (RAs) in [Chapter 2](#), and we'll look at them in detail in [Chapter 9](#). For our purposes here, it's important to remember

that not all retirement annuities are created equal. There are different types and it's vital that you understand what kind of RA you're getting yourself into before you invest.

It could be argued that there is no place for the traditional RAs offered by life assurance companies. Their costing model is beneficial to the assurance company and perhaps the financial advisor, but not necessarily to the client.

There is, however, room for the more modern, unit-trust-based RAs that charge fees on a pay-as-you-go basis. Such RAs are typically offered by unit-trust companies and have been available for a number of years. These RAs are fairly transparent with regard to fees and offer a wide range of investment options.

While cost issues are an important part of choosing your RA, there is still a good case for investing in them. Their direct tax advantages may work for some people, but this will have to be decided according to your circumstances, so get the best advice you can from people not invested in selling you a product.

Unit trusts

Falling interest rates are always welcomed by people with debt, while those who have investment assets, especially retirees, often struggle to adapt. There are many retirees who are so afraid of losing money that they keep their investments in cash via money market accounts and fixed deposits.

Unfortunately, these cash investments don't keep pace with inflation over the long term, especially when tax is deducted from the interest earned. Retirees feel this impact most acutely when interest rates drop, and they start scouting for alternatives to provide them with a better return. This is usually where their problems start, because they can be lured into scams or high-risk investments by unscrupulous salespeople.

People in this predicament must be very cautious and sensible. Offers of great returns with little or no risk should be avoided, as they are usually scams. Always remember that if something seems too good to be true, it usually is.

There is a range of quality investment alternatives that will provide good capital growth and income without involving unnecessary risk. The table below shows the average returns of low-risk, income-generating unit trusts in South Africa and their relation to inflation over a one-year and 10-year period respectively.

Interest and growth of unit trusts vs inflation from March 2002 to March 2012

One-year average	Above inflation
------------------	-----------------

10-year average	Above inflation			
Money market	5.46% p.a.	−0.65%	8.67% p.a.	2.44%
Income	6.86% p.a.	0.75%	9.25% p.a.	3.02%
Prudential Low Equity	9.86% p.a.	3.75%	10.67% p.a.	4.44%
Inflation	6.11% p.a.	n/a	6.23% p.a.	n/a
RSA Retail Bond	7.25% p.a.	1.14%	n/a	n/a

Source: Morningstar

Note: Money market unit trusts are similar to money market accounts at a bank: your money is only invested in cash and only earns interest. Income unit trusts will invest in money markets and will also buy bonds (see [Chapter 9](#) for more on bonds). Prudential Low Equity unit trusts invest in shares, bonds and money markets. The amount of capital that can be allocated to shares is limited to ensure that these funds remain less risky than a typical balanced unit-trust or share investment.

Money market unit trusts have underperformed inflation over one year but have done reasonably well over 10 years. However, low-risk, diversified unit trusts have given far better, inflation-beating returns without any unnecessary risks.

To illustrate the difference in growth, if you had invested R100 000 in the average money market fund over the 10-year period, you would have R229 666, compared to R275 613 in the average, low-equity unit trust. This is a difference of R45 947, which is quite significant when you only invested R100 000 to start.

Low-risk, diversified unit trusts cannot invest more than 40% in shares and therefore will not suffer the massive drops experienced by stock-market investors. You might lose 8% in a really bad year, but you should recover within two years. Cash investors will not have the losses, but they will also not beat inflation over the long term.

If you need to keep cash because you plan to use it within the next two to three years, consider investing in RSA Retail Bonds. They offer the best interest rates on fixed deposits without any charges. This is in sharp contrast to some banks, which charge initial fees when people place money in their money market funds. I find this practice highly unethical, as the initial fees account for nearly 10% of the interest earned within the first year. It takes no real thought or expertise to place money in a money market fund and therefore an upfront fee

should not be charged.

WHAT IF YOU REALISE YOU HAVEN'T SAVED ENOUGH FOR YOUR RETIREMENT?

In this situation, the temptation is to add more capital growth and take on more risk at a stage when you are drawing income from your capital. In fact, what you really need to do is to take *less* risk.

The solution is to reduce your lifestyle costs – and that may mean having to make a complete change. Moving to a small town can save you a fair amount, because the costs of security, insurance and so on are likely to be lower, and rates and taxes are much higher in the city. You will probably also be able to afford a slightly bigger piece of land, which means you might grow your own produce.

You could also take on some part-time work to supplement your monthly income, perhaps for a smaller company that can't afford to take on someone with your expertise on a full-time, market-related basis.

GENERAL PRINCIPLES FOR PEACE OF MIND IN RETIREMENT

Remember that smaller families and smaller populations mean more elderly people will need to arrange for their own care in the future, often through retirement homes or other institutions. These carry costs and need to be planned for early in life.

So, if it's likely that you are going to be retired for the same amount of time that you worked, then you are going to need a massive amount of capital at retirement. That means – once again – you have to save more of your income and spend even less.

Plans to make, people to see

One of the keys to a successful retirement is ensuring that you have a clear plan about how your life will be structured once you have stopped working. Many people suffer from post-retirement depression because they have nothing to do with their time.

I have spent nearly two decades advising retirees on their financial affairs and my happiest clients are those who had a plan for their retired life. While your financial affairs are an important part of the plan, other considerations are

equally important, especially what you will be doing with your time on a daily basis. Many happily retired people choose to work part-time or to volunteer for charities.

Financial well-being at retirement does not mean that you will be happy in retirement. Many wealthy retirees (especially retired executives) are desperately unhappy with their lives. They spent so much time at their jobs that they have no outside interests and therefore nothing to occupy their time once they stop working. You need to start planning other aspects of your retirement about five years before you stop working. As a starting point, plan what you are going to do on the first Monday you're not working.

I tell my clients to ensure that they have three obligatory appointments a week – and I'm not talking about looking after your grandchildren. Donate your time to charity – do the books for the SPCA or a children's home, or offer other services according to your skills. If you have no obligatory appointments to wake up for, your motivation decreases and depression can set in.

For high-powered executives, it is important to gradually scale back your commitments as you head for retirement. Take some non-executive directorship positions, for example, that won't require such a huge time commitment from you.

And don't fall into the trap of ending up as full-time nanny to your grandchildren, where you become a slave to your children's kids. That's bad planning. You have to take your own mental well-being into account, and it's *your* retirement. You've earned the right to dictate how you spend your days.

Plan together

Many married couples really struggle in the initial phase of retirement. Often one person retires before the other, and this can cause real problems. The retired person is now constrained by the partner's work schedule, so holidays and spontaneous long weekends are not possible. This can cause friction in the relationship that can be pre-empted by honest discussions in the months and years prior to retirement. Don't assume that your partner has the same ideas about retirement as you do – you have to discuss it. If possible, try to ensure that both of you retire at approximately the same time.

Where only one person has worked, the situation can be even worse at retirement. The person who has been at home has a routine and life that is independent of his or her partner. When that partner suddenly spends every day at home, it can be disruptive to both people.

You cannot be too young to start your retirement planning. Many people –

myself included – start their planning in their late 30s so that their way forward is clear. From personal experience, I can tell you that this type of planning is very fulfilling and makes my working life more purposeful.

Planning for death

Whether you want to face it or not, you should also start planning for death. Married couples need to keep in mind the well-known fact that women generally outlive men. Traditionally husbands did most of the money planning, and that needs to change. Wives need to understand how the finances work and how the investments are structured. And both spouses need to agree on what the investment strategy is.

Both spouses should meet with the couple's financial advisor or planner and be comfortable with him or her. It's a relationship between three parties.

You also need to keep your will current and have it reviewed every two to three years. Appoint a professional executor – don't leave that function to the bank. That simply adds years to the time it takes to wind up an estate.

Where will you live? Downscaling and the family home

If you are planning to scale down, try to choose the home you want to move into well in advance. Don't make the decision when you are in your late 70s or early 80s. If possible, buy the house and rent it out in the meantime, and/or put your name down on the waiting list at a retirement village or old-age home with frail care.

Also discuss your plans with any adult children you have. Many people retire and decide to stay where they are in order to be close to their children, only to discover their children have plans to move elsewhere. You need to talk about these things.

If you're going to continue living in the family home to keep it for your children, or if you have a holiday home you're keeping for them, it's also best to discuss it with them; they may not even want those homes. It's important to talk to your children about their expectations, and sort those issues out early.

And finally, it might seem obvious, but if you move to a small town, make sure you are reasonably close to a good hospital and have easy access to proper health care.

Case studies: how to change your life

One of my clients, **Anne**, worked for 30 years for a large multinational as the personal assistant to a company executive in Johannesburg. After retirement she moved to a small

house in the southern Cape, where she rents out a small flat on her property to holidaymakers to supplement her pension while earning money from painting.

Painting is a new career for her and is something she had never done before retirement. She simply started art classes with her neighbour as a pastime because she wanted to engage her mind, and found that painting achieved that goal for her.

From this inauspicious start, great things happened. Within 12 months she had sold her first piece at a gallery, and she is gearing up for her own exhibition soon. This is a wonderful example of someone who has made a success out of a hobby because she had the time and willingness to learn something new.

Rick is a retired human resources executive who started a new career as an executive coach after he retired. He didn't really need the money, but as he said to me, 'The extra money will improve my holidays.' He also didn't want to sit at home while his wife was working.

He has been an executive coach for more than 11 years and has found the work to be fulfilling and challenging. And he's certainly used the extra money to good effect – he travels to Europe every two years.

Finally, **Gloria** was a financial manager at a large food company and retired with a well-structured retirement package. She was 65 when she had to stop work due to her company's retirement policy, but she still had enormous energy and wanted to use her time to benefit others.

She started working at a local animal shelter as a volunteer for three days a week, but after three months she had become worn out, as she couldn't deal with the cases of animal cruelty she saw on a daily basis. So she started helping the animal shelter with their financial records instead, and is now their official bookkeeper. She is still making a difference, but she is using her skills more productively and doesn't suffer the emotional drain of working with abused animals.

STARTING A BUSINESS WITH R1 000

I am a regular guest on Talk Radio 702 with Bruce Whitfield on Thursday evenings, when we discuss personal finance topics. One evening Bruce interviewed the American author Chris Guillebeau, who wrote *The \$100 Startup*. In the book Guillebeau reviews many businesses from around the world that were started with an investment of \$100 or less.

After the interview, Bruce challenged one listener and three regular contributors to the show (myself included) to start a business with R1 000. We were given six weeks to see how much profit we could make, and at the end of the period we would give the profits to charity. This challenge sparked a desire in me to prove my point that anyone can generate an income if they are motivated and determined. So here's what I did.

My mother-in-law is a 60-something Afrikaans woman who lives in Tzaneen. Like most people in their late 60s, she does not have enough money to live the

life she wants, and her annual holiday budget in particular is a bit limited. After accepting the challenge, I called her to inform her that my wife and I were going to help her set up a business to win the Radio 702 challenge.

As with many women of her generation, she is a great cook and can make better stews and casseroles than most restaurants. So we agreed that she would start Granny's Good Foods, where we would sell good, old-fashioned, home-cooked meals to working parents.

The list of options would be basic (mainly casseroles, stew, mince and malva pudding) and the food would be packaged to serve either two or four people. The food would be cooked at her home in Tzaneen, frozen and brought to Johannesburg monthly. Each meal was stored in aluminium containers with cardboard lids that were bought from a wholesaler, and the description of the meal was written on the lid.

My wife and I sent an email to friends, family and colleagues. The marketing message was that this food could be kept in the freezer for use on those nights when people were too busy or too tired to cook for themselves. We promised delivery to the buyers if they lived in Sandton; alternatively they could collect it from my office near Hyde Park. We asked people to complete a simple order form and to email it back to us with a proof of payment for the order that they had placed. This ensured that we did not incur a cost before we had an order. (Fortunately we knew all the people who were placing orders, so they trusted us to deliver the food after their payment!)

Our first orders were placed in October 2012, and we received more than R7 000 in orders for the month. The cost of buying all the food, other ingredients and containers was just under R2 000, which meant that we made a profit of more than R5 000 in our first month of business.

In our second month, November, we received more than R8 000 in orders. Thus our profit for the first two months exceeded R10 000. The profits in month two onwards were higher because many of the ingredients and containers had been bought in bulk in the first month and were sufficient for a few extra months. And because it takes less than five full days to complete all the orders, the business can make R5 000 profit per week of work.

My mother-in-law's financial position has strengthened considerably since she started the business. She has seen how her holiday fund has grown and will continue to grow. And our initial R10 000 profit was donated to the Starfish Foundation, an organisation dedicated to helping children orphaned or made vulnerable by HIV/AIDS – which was a wonderful bonus!

The purpose of a business like this is to keep it small and sustainable, without incurring major start-up expenses. For people in their 60s, a small business can

be a nice source of income, but it should not be a source of stress. The business is meant to alleviate financial stress and to make use of spare time – a valuable commodity in today's busy world. With Granny's Good Foods, we proved that anyone can start a business and earn additional income with very little initial capital.

Can you do it?

I believe anyone can start a business in South Africa, especially those who are retired and have time to spare. If cooking is not your strength, I have a few other ideas.

For example, there is a big demand in places like Johannesburg and Cape Town for reliable, trustworthy people to do chores that working parents and other couples don't have the time to do. These include transporting children, shopping for groceries, or standing in queues to collect or renew subscriptions and licences. I often hear working people complaining that they have no time to do these tasks.

There is also a desperate need for reliable handymen in South Africa. High-income earners who have their own homes always have niggling maintenance issues to resolve in their houses or gardens. It is really difficult to find reliable people who will arrive on time and properly fix whatever is not working. The types of tasks include hanging pictures, fixing broken floor tiles, fixing appliances, sorting out plumbing or electrical problems, and so on. Someone who knows a bit about each of these areas and who can properly project-manage the people involved can make a great living.

So the answer to the question is yes. Anyone who is willing to put in the time and effort can create at least a small source of income for themselves, which might make the world of difference.

5

The Entrepreneur: How to Plan Your Finances

Planning your finances requires a slightly different perspective when you're an entrepreneur, which for our purposes can be defined as anyone who sets up or organises a business, taking on financial risks in order to take advantage of an opportunity to make a profit. On the one hand, you're the master of your own destiny to a large degree, and if your business succeeds, you have a far greater chance of becoming highly affluent than the average salaried employee. On the other hand, you take more risks and need to ensure that your finances are correctly structured.

RISK MANAGEMENT AND DIVERSIFICATION

Risk management is the process of ensuring that you are financially protected in the event that your business does not succeed or goes through an extended bad patch. Diversification is part of managing risk because you will need to ensure that all your financial ‘eggs’ are not in one basket – *i.e.* your company. The concepts of risk management and diversification will run contrary to the nature of most people who are risk takers (such as entrepreneurs), especially when they have been rewarded over a period of time for taking risks. Successful entrepreneurs will point out that they get great investment returns from their own business and fail to understand why they should invest their money elsewhere.

My response is that of course you don’t go into business expecting it to fail, but you do need to be realistic. Businesses do fail, however good the intentions of their owners might be, and for a variety of reasons. And so it’s important to build up a nest egg outside of your own company to ensure that you and your family will be financially stable in the event of a business failure.

Think of a successful entrepreneur like Donald Trump. He has proven that it’s possible for even self-made billionaires to have numerous failures in a long career. And without a nest egg, the distress caused by a business failure will be infinitely worse. Even if it is not viable for you to allocate any capital to other investments during the early stages of a new business, you should still aim to get to a point where you divide your capital between ‘risk capital’ and your nest egg. This allows you to build up a buffer if things go wrong with your business and gives you the freedom to take risks within your business without concerns for your immediate financial future.

Another area of concern for a business owner who is considering investing outside the business is the issue of control. Many of the best entrepreneurs are fixated on having control over their business, expenses and other important aspects of their financial lives. This makes it difficult for them to place money into investments where they don’t have control, which could lead to poor investment decisions.

There are people who decide to invest in the stock market because they don’t trust an asset manager and/or don’t want to pay the fees. But it takes a considerable amount of research and commitment to invest properly on the JSE. If an entrepreneur invests in the stock market in an attempt to build up a solid diversified portfolio without doing the necessary homework, he or she might end up losing capital through poor investment decisions rather than creating a

financial nest egg. In other words, there are times when it might be better to get expert advice when you're investigating new areas of investment – especially when you are busy running your own company.

It's important to ensure that you have proper diversification of your investment capital. Many entrepreneurs will attempt to diversify out of their business by investing excess capital in another small business or in a property investment. While this is a diversification out of the owner's business, it is still high risk, as a small company carries more risk than a large firm. The same applies to an investment in a single physical property, as this is a highly concentrated investment and is therefore high risk.

It would be wiser to develop a portfolio of assets that carry low investment risk and are not related to the entrepreneur's business. Furthermore, these assets should be diversified across different types of asset classes such as government bonds, commercial property, shares and some cash (via a money market account). It is important to understand that this capital may not achieve the same returns as your own business, but they will carry less risk and will provide you with some stability in times of uncertainty.

You should aim to invest sufficient capital so that you can live off the investment income and not rely on your own business to meet your living expenses. It might take a long time to reach this level of investment, but you should aim to achieve this goal as quickly as possible. You can start small, via a monthly investment, and add any lump sums that you generate from your business to the investment.

Once you have built up a sustainable nest egg, you will be able to reinvest excess capital back into your business or into other high-risk, high-return ventures. You will have the security of knowing that you and your family are financially secure in the event that your business hits a rough patch. This will allow you the freedom to manage your business as you feel necessary.

If things go wrong in your business, it is important to resist the temptation to use your nest egg to fund your business. Too many entrepreneurs continue to fund their failing business with any available capital in an attempt to keep their companies afloat. Proper discipline and sound decision-making are important in these situations because you may need your capital to look after your family until you find your feet again.

SUCCESSION PLANNING AND EXIT STRATEGIES

There are countless business owners who reach their desired retirement age and find that they can't get a decent price for their successful business. This forces the business owner to make some difficult decisions about whether to work in the business longer than planned, sell the business at a massive discount or continue working on a smaller scale in a semi-retirement position. None of these options are ideal and they may have a detrimental effect on later quality of life, but this situation can often be avoided with proper planning at an early stage.

Business owners must plan their exit from their businesses and they should do so as early as possible. Many business owners spend all their time and effort running their business and don't think about their own future separate from the business. The problem arises when they decide it's time to stop working. At this point there are a number of options, such as selling out, taking on a partner who buys into the company, hiring a manager or handing the business over to a member of the family. All of these options require some preparation.

In a perfect world, you should explore your options for an exit strategy once you have established your business as a viable operation. This allows you to plan ahead and work towards a goal. If you decide that the best way to exit your business is to sell, then you will need to manage the finances of your business so that potential buyers find it attractive. If you plan to hand over your business to a family member or if you plan to bring in a partner or manager, then you should do so a few years before you decide to exit. This will allow you to put systems and structures in place so that you can remove yourself from daily management tasks and take on a more strategic role. It also reduces your business's reliance on you and will force you to put the right people and systems in place to ensure it continues to grow without you.

Depending on the nature of your business, it is important that potential buyers see the value of your business as a distinct entity from you. Selling a business that is overly reliant on your skills and expertise means the business will have limited value when you exit.

People who operate as consultants often make the mistake of thinking that they can't create a business that will continue when they are not involved. Usually they are too busy consulting, which prevents them from creating a proper business that develops a life of its own. By developing a management system with proper support structures, a business owner can convert a one-man

band into a viable business that can be sold.

MANAGING YOUR TAX INSTEAD OF YOUR PROFIT

Many business owners make the mistake of managing the finances of their businesses so that they pay the South African Revenue Service (SARS) as little as they legally can. This is usually accomplished by running every possible expense that the business owner incurs through the business. If they can find a way to pay their spouse, they will do so. While it is your right to do this if you are acting legally, you should keep in mind that potential buyers of your company will be most interested in the profit generated by your business *after* tax. This means that if you have been limiting your taxable profit, you have also been reducing the value of your business to potential buyers. It is important to strike a balance between your tax management and profitability, especially if you are thinking about selling your company in the next few years.

One of the key ratios that potential buyers or their advisors use to value a business is the price-to-earnings (P/E) ratio. This is the price of the company divided by the company's profitability after tax. The P/E ratio indicates how many years of profit would be required to repay the price of the company. This is a valuable ratio, as potential buyers can benchmark your company against similar unlisted companies and companies listed on the stock exchange in the same industry.

You can find the P/E ratio of all listed companies in the shares pages of most newspapers. A high P/E ratio, *e.g.* 20, means that it would take a buyer of the company 20 years of profit from the company to recoup the amount the buyer paid for it. A P/E ratio is certainly not the only method of valuing a company, but it is often used as an initial measure to see whether or not the price of the company is reasonable. If the buyer thinks the P/E ratio is acceptable, then he or she might take more of an interest in the business.

If you own a business and plan to sell it in the future, you will need to take into account how buyers will value your business. It is important to understand that they will want to see a good history of growing profit over a period of two or three years at least. This will allow them to determine a realistic valuation of your business and offer you the best possible price.

The only time that a potential buyer would not be too concerned about your company's profitability is if the buyer can take over your clients and get rid of most of your costs. This usually happens when a business is purchased by a

competitor who has the necessary infrastructure to handle the extra volume from that business. In this type of scenario, it is likely that the buyer would value the income generated by the business more highly than the profitability.

The main point here is to understand that outsiders will not place the same value on your business as you do. If you want the best possible price for your company, then you will need to structure your financials so that they are most attractive to a buyer.

6

Budgeting and Debt Management

Do you want to stop worrying about money? Do you want to go on those dream holidays? Do you want to be financially independent?

You can do all of these things – honestly. It's simple, and it all starts with your budget. Nearly all of the financially independent people I have worked with have been disciplined with their budgets. They all succeeded in making it a lifelong habit to spend less than they earn. People who have created their own wealth run a monthly budget as a natural part of their lives. It is not something that they do only once a year or when they are in financial trouble.

The first and most important step to achieving financial freedom is spending less than you earn every single month. More than 80% of those who work for a living cannot regularly do this, sometimes because money is very tight, but more often because it takes so much discipline. I realise that it is not always easy and that there are many instances when life throws you an unpleasant surprise that costs you money. However, control of your budget is the most important factor in determining your long-term financial well-being.

There are a lot of similarities between financial discipline and physical discipline. If you spend 30 minutes on the internet, you can find a range of quality exercise plans that will help you to get and keep fit. And yet there are so many unfit and obese people in the world who do not have other health problems. Why is this so? Because most people don't have the will to be disciplined about their fitness over long periods of time. In the same way, most people don't really have the will to be financially disciplined over their entire lifetimes.

BUDGETING IS KEY

Many of my good friends live in beautiful large houses with swimming pools, tennis courts and massive gardens. In addition, they drive big luxury SUVs. To outsiders, they are living 'The Dream' and are a constant source of envy. But sadly, nearly all of them have enormous levels of debt that will cripple them if they no longer earn an income.

As a good friend, I have often tried (without nagging) to show them how excessive debt can damage their long-term future. Unfortunately, however, most of them believe that the future will take care of itself. What many people don't realise is that they need to make compound growth work for them instead of against them. And the only way to do this is to be debt free and then to accumulate savings consistently over long periods of time. All of this starts with a simple budget.

How to start budgeting

Any budget must be realistic. This means that you should look at your current expenses and use them as the basis for your budget going forward.

You won't be able to change your whole life overnight, so don't plan a radical change to your budget where you suddenly resolve to spend half of what you were spending every month. Instead, start small. Make incremental changes that you can maintain over time, gradually spending less and saving more.

This is the same principle people use to lose weight successfully. No crash diet is sustainable in the long term and the after-effects leave you in a worse position than before. The best way to change your weight over the long term is to gradually reduce your portions and to progressively change what you eat. As someone who lost 13 kilograms over 12 months in 2006, I can tell you that I have managed to sustain my new weight for more than seven years (and counting) through consistent but realistic discipline. Your budget needs to follow the same process.

Set a goal

If you are a salary earner, aim to save 15% of your total salary every month. So, if you earn R10 000 a month before tax and deductions, then you need to save R1 500 per month. Even though most large companies will also contribute to a retirement fund on your behalf, you still need to save a total of 15% of your salary, so you will need to save some extra money yourself. Throughout your

career, you need to save at least 15% of your total income in order to be sure of having enough money to retire. If you currently spend everything that you earn, then you need to start working towards the goal of saving 15% of your total salary.

In this regard it's helpful to analyse how you are currently spending your money, using your last three months of expenses as an indicator. In setting your budget, put your expenses into categories – groceries, clothes, entertainment, property, *etc.* Once you have categorised your expenses, you can then get a total for each category, which makes it easier to monitor yourself on a monthly basis.

If you are not good at record keeping, try making use of a budgeting tool, a number of which can be found on the internet. For example, look at the budget tools on the websites www.22seven.com or www.moneysmart.co.za. Both are very helpful tools that automatically track and categorise your expenses for you. The only tricky part might be that you need to stop using cash, or keep track of how you spend your cash yourself. In any case, once you have an idea of how you spend your money, you can develop a game plan for reducing certain expense categories on a monthly basis until you have reached your savings goal.

If we stick to the example of saving R1 500 a month, look at your categories of expenses to determine how you are going to reach the R1 500. For example, if you spend R3 000 on food and entertainment, try to reduce this by R100 a month until you have reached your targeted saving, *e.g.* R500 per month. You should do the same with your other categories, such as cellphone, clothes and vehicle repayments.

A word of warning

I have met a number of people who have started budgeting for the first time and their first inclination is to reduce their insurance expenses as an easy way to cut costs. They often cancel their vehicle insurance, medical cover and life assurance. This is definitely *not* the way to budget effectively!

When you have limited financial means, your insurances are vital. If you have a car accident and your car is written off without insurance, you are going to be financially devastated, especially if the car is financed. You need to maintain your life assurance and your disability, medical and vehicle insurance – these are not items to cut out of your budget when you are in a tight spot.

There are no quick fixes

Unfortunately there are no quick fixes to budgeting. You will always need to sacrifice something in order to achieve your goals. Much as professional

sportsmen need to sacrifice by avoiding late nights, junk food and alcohol, you will need to make sustained sacrifices.

This doesn't mean that you need to live like a hermit in a cave. If possible, your budget should include an allocation for frivolous expenses, but they must be controlled. This is the same principle as I use in my eating plan – I always allow myself to relax my discipline a bit over weekends. This enables me to enjoy the food I like on weekends, and during the week when I really want that burger, I know that I can have one over the weekend. It's the same with spending: it's amazing how often that craving disappears if you delay your purchase by a few days.

Your budget also needs to be realistic, because you will need to stick to it for your entire lifetime. As with most good habits, it is tough to *start* budgeting, and the first few months are going to be the most difficult, but it does get easier. If you are disciplined for a few months, you will find it becomes second nature to be careful with your money. Eventually, you will look back and be amazed at how much you have saved and how easy it was.

It is important to remember that the only way to be successful with your money is to take control of it. Being a slave to your debt is a horrible way to live. You will always have a nagging fear of losing your job, which will make it impossible to repay your debt. This fear can impair your performance at work, which makes it more likely that you will lose your job. I truly believe that we should avoid all debt wherever possible. The only way to live debt free is to be a budgeting guru!

MANAGING YOUR DEBT

I have already discussed debt earlier in this book, and I will do so again here and in later chapters. If you have already concluded that I think debt is not a good thing for most people, you are 100% correct. There are a few (very few) instances where debt can be productive, but only if you are using the debt to purchase income-generating assets. In all other instances, debt is one of your worst enemies and is the main reason why the majority of people do not become financially independent.

I believe there are three categories of debt: bad debt, neutral debt and good debt. Let's look at each of these and their implications for your financial well-being.

Bad debt

Most types of debt fall into the 'bad' category and should be avoided at all costs. This is debt that is used to purchase items that do not generate income, will lose all value or might be consumed. Examples of bad debt include bank overdrafts, credit card debt, store card debt, and so on.

I cannot think of a situation that would warrant someone using bad debt ... ever. The interest rates are so high and the payment terms so inflexible that this type of debt is nearly guaranteed to make your existing troubles even worse. Using this kind of debt is a guaranteed wealth destroyer and will ensure that you never break the debt cycle.

Neutral debt

Neutral debt refers mainly to debt incurred to purchase vehicles. Most people cannot afford to buy a vehicle with cash and therefore they have to finance the purchase. Their vehicle debt will be neutral if they buy a car they can afford and pay off the loan quickly.

Unfortunately, most people spend far too much on cars. They tend to determine the suitability of their vehicle purchase based on how much they earn and what their monthly repayments will be. For example, if they earn R8 000 after deductions, they believe they can afford the car if the monthly repayments are R5 000. But they will barely have enough left over for running the car (insurance, petrol, etc.), not to mention food, rent or bond repayments, savings, and so on. In instances like these, your vehicle debt becomes bad debt. If you are going to finance a car, make sure that the monthly repayments are no more than

30% of your take-home pay. If you receive R10 000 in your bank account every month, then you should spend no more than R3 000 on vehicle repayments.

Keep in mind too that unless you are financially disciplined and a good investor, you should *never* finance a car with a balloon payment or residual. This is when you are required to pay a lump sum at the end of your vehicle-finance period. This type of debt structure is designed to make an unaffordable debt seem affordable. Rather pay a big deposit to reduce your monthly repayments.

If you are not financially disciplined or if you are uncertain about your future income, try to buy your vehicles with cash.

Good debt

Many fortunes have been created and destroyed by people using debt to buy growth assets, or productive assets, as I prefer to call them. These are assets that are able to generate an income and have the potential to increase in capital value, too.

The theory behind good debt is simple. For example, you can buy a house with a mortgage and rent it out. Over time, your rent should exceed your bond repayments and so the property eventually pays for itself. But if you are tempted to use debt as a way to create wealth, it is important to understand the nature of the asset you are buying and the certainty of your income before making the big decision. Sticking with the house theme, if you had bought a house with a 100% mortgage at the peak of the property market in 2008, you might be in financial difficulty now.

For most properties, the rental income has stagnated or declined from 2008 to 2012 as large numbers of people have lost their jobs. In addition, electricity and property taxes have increased substantially. If you were relying on rent and your own income to pay for the property, you would be in deep trouble if both you and your tenants lost your jobs. This is not an unlikely scenario and it certainly happened to hundreds of people in South Africa during the financial crisis of 2008/09.

So, you should be very careful when using debt to build your wealth. Start by determining whether the asset you want to buy is really a productive asset. Productive assets are those whose capital value is likely to increase at a faster rate than inflation. In addition, these assets might also generate a regular income.

For example, farmland is a productive asset because it should appreciate in value and will produce goods that can be sold regularly. Other types of productive assets include commercial property and ownership of businesses. Government bonds can be productive assets if they generate an inflation-beating

income. On the other hand, I am not convinced that money markets (cash) are productive assets, because your interest is unlikely to exceed inflation over the long term.

Once you have decided on an appropriate productive asset, it's important that you don't take on too much debt to purchase it. You need to be sure that you will be able to repay the debt in all circumstances. For example, if interest rates rise by 5% from current rates, will you be able to fund the debt? If you lose your employment, will the income from the asset be sufficient to cover the debt repayments? If not, do you have sufficient cash reserves to fund the shortfall until you get another job?

I am highlighting these points because they can derail the best-laid plans. This does not mean you should not use debt to buy productive assets; you just need to exercise caution. Many wealthy people have created their fortunes using some debt. For example, some academics argue that Warren Buffett built his multinational investment company Berkshire Hathaway into a multibillion-dollar business through gearing. Gearing is usually indicated as a percentage and shows how much debt a company has as a percentage of its assets (called equity). If a company has assets worth R100 000 and debt worth R60 000, then its gearing is 60%. It could be argued that Buffett used money that the company did not actually own – *i.e.* debt – to buy quality investments. To illustrate, when he bought shares in Coca-Cola, for example, he might have bought \$160 million worth of shares, but as Berkshire actually only had \$100 million, the balance was borrowed. As the dividends from Coca-Cola were paid to Buffett's company, he used them to pay the financing costs on the \$60 million. Over time the \$160 million increased in value substantially and made the original debt seem minuscule in comparison to the new value of the shares. People who are successful in building their wealth with debt are able to exercise good judgement with the purchases they make and the level of debt that they take on to fund the purchases.

I believe the optimal level of debt on productive assets for any individual is 15% to 60% of that person's assets. This means that if you have R1 million in assets, you should borrow a maximum of R600 000 to buy more productive assets. No doubt some people would argue that you could take on more debt to be more tax efficient and to generate better growth more quickly, but I believe you can't rush wealth creation. If you want to become wealthy in a short space of time, you will need to marry someone rich, become a corrupt politician or resort to luck. If you want to take a calculated risk with a high probability of success, be conservative with your debt and be patient.

7

Step Away from that Property

South Africans seem to have a fixation on residential property as an investment. From the time we are very young we are told that owning property is a good idea – that we should pay our own mortgage rather than paying someone else's through rent. And so, when we start work we duly find a home, with the burden of a mortgage, and embark on our lifelong property adventure.

As we grow older, we require more space and therefore a bigger house and larger mortgage. This carries on until we retire and decide to look for a smaller home – hopefully this time without the need for a mortgage. But how many of us ever stop to think about whether this is the right way to manage our lives? Most of us just keep doing things because that's the way things have always been done. And believe it or not, there is an alternative view to property ownership.

PROPERTY AS AN INVESTMENT

Let's look at residential property as a 'pure' investment by comparing it with other investments. To do this effectively, we need to look at the growth or performance of residential property and see how well it has grown over time compared to other investments.

The table on [page 78](#) shows the growth of residential property against the share market, property companies, government bonds, cash, mortgage (interest) rates and inflation. The growth is calculated annually and is shown over very long periods of time. The reason we look at long-term growth is that it eliminates the distorting effect of short-term trends and therefore gives us a proper perspective on these investments. The data below are accurate to the end of 2012.

South African asset classes: long-term performance, 1900–2012

Asset class	Indicator	Long-term average growth, after inflation ^a
Residential property	ABSA House Price Index	1.9% ^b

Property	Price Index	
Share market	All-Share Index	7.5% ^c
Listed property	SA Listed Property ^d	6.4% ^e
Bonds	All Bond Index	2.0%
Cash	STepl Call ^f	1.0%

^aAnnualised.

^bSince 1966.

^cUpdated annually since 1900.

^dPrior to 2006 this was SA Real Estate Index.

^eSince 1983.

^fInterest-rate benchmark for large funds and companies.

From the table we see that the best-performing investment (asset class) is the share market. Over the long term it has beaten inflation by 7.5% per year, while residential property only ranks fourth, outperforming inflation by only 1.9% per year.

It's also important to look at the costs of your investment. In the case of home ownership, one of the major costs would be a mortgage or home loan. The average mortgage interest rate over certain periods has been higher than the nominal growth on property (that is, before inflation). This means that investors in residential property actually paid more in interest than they gained in growth on the value of the property. Hopefully you understand by now why I believe that mortgaged residential property is a poor investment over the very long term.

However, mortgage interest is not the only cost of owning a home. There are also the initial costs of buying the home. These include transfer duties, bond registration and legal fees, which might be as much as 2.5% to 8% of the value of your home. In addition, you will need to pay an estate agent 3% to 7% to sell your home when it is time to move. And then there are the maintenance costs – ask any homeowner if a month goes by without something having to be fixed or improved. These costs could average as much as 1.5% of the value of your home per year.

Those who are still unconvinced that residential property is a poor-performing asset are probably thinking that at least property is a low-risk investment. But there are some significant risks to consider, including concentration and

liquidity. Concentration risk means having too much of your capital exposed to one investment (having too many eggs in one basket), and liquidity risk means the ability to sell an investment quickly.

As an illustration, let's look at residential property in the Cape Town suburb of Sea Point. In the mid-1980s, Sea Point was a sought-after residential suburb, but by the mid-1990s it was in the midst of price depression. Rental yields were low and sellers were unable to get their expected prices. Investors who had bought property in the early 1980s with the expectation of earning a good rental yield or capital appreciation over a five-to 10-year period would have incurred significant losses. However, since the early 2000s, there has been a recovery in the Sea Point property market, so investors who sat out the depression would have had a recovery in their asset values.

In contrast, people with more liquid investments, such as shares or listed property, would have been in a better position in a declining market. They would have been able to sell their investments quickly and would have had a spread of investments rather than one single share or listed property. In South Africa the stock market usually recovers its losses within 12 to 18 months after a big decline; this is significantly faster than a recovery in the property market.

Another factor to consider is the value of the capital that you have tied up in your home. Effectively, it's not working for you. For example, consider a retired couple who live in a R1-million home that is paid off and who have an additional R1 million in free capital. They could sell their home and use the R1 million to provide additional income and eliminate the cost of homeownership.

If the property that they rent instead costs R7 000 a month, they would still have an additional R3 000 to R4 000 in disposable income that would be created from the savings on municipal rates and maintenance. If the R1 million is properly invested, the capital should grow by more than the inflation rate and therefore the capital can be used to further supplement the retirees' income. By comparison, the rent paid by the couple should only increase with inflation.

International performance is similarly poor

South Africa is not the only place where the performance of residential property as a pure investment is less than stellar. A brilliant study completed in 1994 by Piet Eichholtz, titled *A Long Run House Price Index: The Herengracht Index, 1628–1973*, shows the returns of property in the Herengracht district of Amsterdam. This study shows that over nearly 400 years, real house-price growth has averaged only 0.5% per annum over the entire period. The results are

fairly consistent over each century too, with the lowest real growth of -0.2% per annum occurring in the 18th and 20th centuries and the highest real growth of 1.3% per annum occurring in the 17th century.

This study is valuable in that it focuses on one specific area in which the houses have not changed in size (it's a historical site) and which has always been considered a prime residential area, so performance has not been affected by urban decay. What it shows is that residential property basically tracks inflation over the long term. In other words, one should not expect an investment in a home to beat inflation.

THREE FACTORS TO BEAR IN MIND

1. Your home is not an investment – it's a lifestyle asset

The only time your home is an investment is when you use the mortgage as leverage to buy income-generating investments. If your home is worth R2 million and you take out a R1.5-million mortgage on your home to buy a rental apartment, then your home becomes an investment.

If your home is paid off, it is simply a lifestyle asset because it costs you money to live there. Like all lifestyle assets, it has value and can be sold, but it can't generate any income for you. Many people derive great value from the security of owning their own 'castle', but if you're never going to sell it and live off the capital, then it is not an investment.

2. You can borrow money to buy property

It's usually quite easy to borrow money from a bank to buy a house if you are in a reasonable financial position. For young people who are starting out, they will find it easier to borrow money to buy a house than for any other purpose, especially if they earn a good salary. If you are disciplined in paying off your mortgage quickly, you can use your house as an asset to borrow money to buy other investments. I am not necessarily advocating this, as this is a very risky way to make money, but it is possible.

This doesn't mean that you can't borrow money to buy shares, but it is certainly more difficult. Typically you need to have capital already invested in shares, which you then cede to the bank as surety. This will allow you to borrow money to buy additional shares. You will usually be able to get a loan of 30% to 50% of the value of the shares you own, provided they are large, well-established companies. Smaller companies are viewed as higher risk, which means you might not get a loan at all.

3. Making profits on property requires work

There are certainly many people who have built massive fortunes by investing in property. There are also many people who have made fortunes on the share market. Both groups of people have turned their investing into a business – that is, they have become professional investors. But for someone working in a different career who doesn't have time to be a professional investor, it would make far more sense to invest in an exchange-traded fund (ETF, or an investment fund that trades on the stock exchange) for 15 years.

The time, effort and expertise required to be a property investor is significant. You can't simply buy a rental house and forget about it for 15 years. You have to ensure that you have tenants, maintain the property, and pay the levies or rates. You will also have to monitor the area around the house. Over 15 years it is likely that the area will change – either it will become more desirable, or it will decline. Some estate agencies offer a 'rental management' service where they find you tenants and manage your property for you. You need to be very careful before taking on such a service, as the estate agents may promise a lot, charge a fortune and actually do very little. From painful personal experience, I can tell you that the agents often do not vet the tenants properly and rarely take any real interest in maintaining your property. Over the long term, if you want to make money from rental properties, you will need to manage the properties yourself or hire a *very* reliable person to manage them for you.

Once you are doing active work on your investments on a daily basis, you are no longer a passive investor but an entrepreneur running a business, which in this case happens to be property investing. On that basis, you could make substantial money because you are going to be spending significantly more time on your investments than most people can afford to spend. This is an important difference, as most people are passive investors and cannot actively work on their investments.

WHEN TO BUY A HOUSE

The best time to buy a residential property is when the rental cost is more than the monthly bond payment. This doesn't happen often, and when it does, you should take advantage because house prices are bound to increase substantially.

This last happened in South Africa in the mid-to late-1990s, but that opportunity has now disappeared as prices have normalised. Don't expect this to

happen very often in your lifetime, as it normally takes place after a major economic crash or because of artificial circumstances (such as changes in legislation).

The numbers back up this view. A model I had built to investigate this issue showed conclusively that it can be more cost-effective to rent a home while saving money and then buy your home with the savings after 10 to 12 years. However, there is a very big 'but': *you have to save the difference between your rental payment and your bond repayment every month for the whole period.* The savings must be invested in the stock market (you could use an ETF) and would be used as a lump sum to buy your property within the 10-to 12-year period.

These results were eye-opening for me and provided a new twist to an old debate. People who followed this course of action starting in 1990 were in a position to pay 90% of the purchase price of their home by 1999, despite the fact that the property market had experienced some good growth over the period.

If you are disciplined with money and can save according to a fixed schedule, you should strongly consider the rent-and-save model. If you are not disciplined with money, however, then the fear of losing your home might be enough to warrant buying instead.

I often advise people who are not financially disciplined to buy the biggest home they can afford because I know that they will at least pay off their mortgage. My hope is that when they retire, they can move to a lower-value property and use the capital raised from the sale of their home to supplement their retirement. This is certainly not an ideal way to save for retirement, but it is better than doing nothing.

Unfortunately, there is no magic financial model that can protect you from your own financial frailties, so rather be honest with yourself before making serious financial decisions. There are also important lifestyle issues that cannot be factored into a financial model.

BUYING LISTED PROPERTY

Considering the transaction costs and investment risks of purchasing residential property on a buy-to-let basis, I am amazed that more people don't buy listed property companies instead. Just to clarify, listed property companies can be bought and sold in the same way as normal shares on the stock market. Each property company owns many different properties across a range of areas. In addition, they usually own shopping malls, office blocks and industrial buildings, so you get a diversified portfolio of properties with one share. The property company manages the properties and the tenants, so you have no

administration hassles with these investments. If you need money from these investments, you simply sell them as you would any share; there are no waiting periods. The yields, investment risks and transaction costs make this a considerably better investment prospect than residential property. Let's compare the costs and potential returns of each.

Purchase and sales costs/fees

Residential property: The transaction costs involved in purchasing a residential property are very high. Estate agent commissions range between 3% and 7%, transfer fees average around 6%, and there are legal fees and other taxes that may be incurred in the purchase. These fees could easily add up to 12% of the purchase price of your investment.

In addition, there is a lengthy process of transferring the property from one owner to another, a process that might be further lengthened if the seller's tax affairs are not in order, as SARS will not approve a property transfer for someone who owes them money.

Listed property: You can buy listed property companies on the JSE either through an account at a stockbroking firm or via property unit trusts from your financial advisor. Here the transaction costs are much lower: brokerage fees of 1.5% for smaller transactions, plus some other costs that would not add more than 0.5% to the cost. In total, you would not pay more than 2% as a transaction cost to buy listed property via a stockbroker.

Annual costs/fees

Residential property: If we assume that you have sufficient capital to buy a house without financing, your running costs would include rates/levies and maintenance on the property but no finance charges. Even if your rental income is sufficient to cover the rates/levies, you will still have to pay maintenance costs. And there might be periods where you are unable to rent out the property.

It's wise to keep track of how much all of these costs add up to over a year to properly calculate your investment returns – costs are likely to be in the region of 8.33% per annum. If you halve this number to ensure prudence in your income forecast, you will still be paying running costs of 4.16% per annum – excluding monthly finance charges if the property is bonded.

Listed property: You don't pay annual fees on your listed property company, but you will have to pay some monthly or annual fee for a brokerage account.

This normally averages around R50 a month or R600 a year. As a percentage of an average house price (e.g. R500 000), this would amount to annual fees of 0.12%, assuming the listed property isn't financed.

Financing your investment

Most banks will lend money against a listed property portfolio – normally up to 50% of the value of the portfolio, which equates to a 50% deposit on a house. The biggest difference is that you don't need to start a property portfolio with R500 000; you can start it with virtually any amount as long as you cover your brokerage costs. I would suggest a minimum of R10 000 as an initial investment, provided you add to this amount on a regular basis.

Income tax is payable on the dividends from listed property companies much the same as rental income from rented property is taxable. When a company makes a profit, it might decide to pay some of that profit to the owners of the company (shareholders). The payment to shareholders is called a dividend, and the amount paid to each shareholder will be determined by the amount of shares that he or she holds.

Yields

If we consider the long-term income (yields) generated by these investments, it's highly unlikely that residential property as an asset class will yield more than 5% to 8% per annum, while many of the listed property funds yield 6% to 11% per annum. These yields show the value of the income generated by the property as a percentage of the current value of the property.

For example, if the property generates R50 000 per year and it is worth R500 000, then the yield is 10%. With a track record of higher long-term yields, listed property is a more attractive investment than residential property.

Given all the factors mentioned above, you have to ask yourself why South African investors are so fixated on buy-to-let residential property as an investment.

WHAT DRIVES PROPERTY?

All property investments are heavily influenced by interest rates. When interest rates fall substantially, property prices usually increase a great deal. Similarly, when interest rates increase, property prices tend to decline.

A country's economic growth also has a major influence on property investments, although the effects of this influence are often delayed. If the

economy grows substantially, property prices tend to rise, but there are major lag times between this economic growth and the resulting price appreciation. Similarly, the economy could stagnate and property could still continue to go up in price for a few years.

Most large properties or developments are valued according to the level of income they generate rather than the actual value of the land or the building. Any factors that hamper rental income are likely to have a direct impact on prices of commercial and industrial properties. Other factors such as population growth, electricity costs, the political environment, legislation changes, crime and sentiment are also factors that affect property prices.

PROPERTY SYNDICATIONS

Despite being the cause of some of the biggest investment collapses in South African history (e.g. Sharemax and Masterbond), property syndications still attract unsuspecting investors who are looking for income. This means it is usually retirees who are most attracted to syndications and who are therefore the most frequent victims when things go sour.

Some property syndications are massive investment schemes with thousands of investors. The idea behind a syndication is that you become part owner of a property that pays you an income and hopefully a capital profit when the property is sold. In essence, a property syndication is a hybrid between a unit trust and a direct property investment.

The attraction of these syndications is that you get a high level of income to compensate you for the risk of making a long-term investment that can't easily be converted into cash. The theory behind these syndications is excellent, but the way they are implemented is cause for concern.

Syndications are almost always created for individual property developments rather than a collection of different properties. Unfortunately, these syndications are often complex in structure and investors don't actually buy shares in a property business. Most syndications sell shares in a company, which then lends money to another business to buy the physical property. The loan is not secured, meaning the property is not used as surety for the loan, so you might get nothing if the syndication fails.

It's important to note that you have no guarantees with this investment. Your capital and income are always at risk, because you are not actually buying a share in a property business. Your property investment is a loan to a property business.

One of my primary concerns is the difficulty of selling a syndication at a fair

price before the underlying property is sold. The promoters of these schemes will tell you that they can assist with the secondary trading of these investments, but in practice this is not so easy. In fact, it can be very hard to sell your shares in a syndication.

If you are lucky enough to sell, you might take a substantial knock to the capital value of your investment. In addition, the syndication promoter will also take a fee for helping you to sell your shares, and this can be as high as 7.5%, which further reduces your capital.

With unlisted property investments like syndications, you also don't have the same level of transparency and reporting requirements as listed companies or unit trusts. This means there is more scope for abuse and you have less chance that someone will be able to monitor the syndication effectively.

Costs and commissions

There are usually two parties involved in the ongoing management of a property syndication and both parties charge annual fees. There is a property management company and a syndication administrator, and both companies are usually owned by the scheme promoters.

The administrator and property management company can charge as much as 2% to 4% each per year; this means 4% to 8% per year in total. These fees are excessive when compared to a property unit trust, which charges an average of 1% to 2% per year. The fees can become even higher over the remaining years of the investment, as they usually have a contractual escalation whereby their fees increase annually for a fixed period. Often the increases are set at rates that are above inflation – for example, at 10% per year. As property rentals are usually linked to inflation, it is likely that these increased costs will start eroding your income substantially in future years.

In addition to the management costs, there are sales commissions that are paid to brokers who can earn between 3% and 6.5% commission to sell syndications to their clients. Most of this commission is paid upfront, which should be a concern to any investor. It means the brokers have no ongoing financial interest to ensure that the investments perform as expected.

The entire financial planning industry is moving away from upfront commissions – most professional advisors don't charge substantial upfront fees. This should apply to all long-term investments, including property syndications.

Are you paying a fair price?

Most property syndications have another flaw that is created at the inception of

the syndication. The promoters of these schemes usually buy a property themselves (via another company) and then sell it to the syndication for a profit. The promoters can make an initial profit of 20% to 40% during this first phase in addition to the ongoing 4% to 8% per year in fees and the capital profit they will make when the syndication eventually sells the entire property.

It is difficult to argue that there is complete independence in this process and that all parties are operating in the syndication's best interests. If your syndication starts with a property that is too highly priced, it will reduce your potential for capital growth over the life of the investment. It also means that your income as a percentage of the value of the property might be lower than anticipated.

I can't think of too many compelling reasons to buy a property syndication. Furthermore, the issues around transparency, costs and liquidity concern me enormously. My suggestion to those who are looking for good property returns is to buy a listed property company instead. They are highly regulated and have excellent liquidity, which means you can sell your shares very easily in a transparent market at reasonable costs.

8

Investments 101

At the time of writing, the world is still coming out of one of the worst recessions in living memory. Many investors seem to be losing their capacity to deal with the massive uncertainty that we have experienced since 2008, a phenomenon I call investor fatigue. In the midst of all of this, it's understandable if you feel a little at sea, and wonder if stashing your money under the mattress might not be a safer bet. After all, some of the world's largest financial institutions have been brought to their knees.

But the theory behind the investing business is quite simple, and it's easy for anyone to implement over time. On the flip side, however, successful investing also requires patience and discipline, without which financial independence is beyond most people's grasp.

The key is to focus on the things you can control, and understanding how investments work is a good start. But there are also other factors you can control to ensure that your personal financial ship is able to navigate the choppy waters ahead.

We can say that there are five basic steps to follow if you want to become financially independent:

1. Create a realistic budget.
2. Make sure you have no bad debt.
3. Build up a cash safety net.
4. Reduce and eventually eradicate all debt.
5. Build your investment portfolio.

We've already discussed steps 1 through 4. In this chapter we'll look at the fifth step, how to build your investment portfolio. But it's important to keep in mind that the steps need to be completed in sequence. There are many similarities between building financial independence and building a house. If you don't build your house in the right order, it will eventually collapse, and the same holds true for your financial freedom. So, once you have completed the first four steps, you can start investing your money to meet your financial objectives. The sooner you can begin this final step, the longer you have to build your capital

over time.

HOW TO BUILD YOUR INVESTMENT PORTFOLIO

No matter what you earn, financial success is within your reach – provided you apply planning and discipline. Before we look at the various investment options, let's consider the five steps you need to follow to invest successfully:

1. Define your investment objective.
2. Establish how much money you can put into your investments each month.
3. Decide what assets to buy.
4. Get started on buying shares.
5. Keep it up!

1. Define your investment objective. As with every action in your life, you are best off if you know where you are headed. Your investment objectives will inform every decision related to your investment activities. For example, your goal might be to put together a certain amount to pay for your child's education in five years' time. Or you might have a long-term plan of providing for retirement. A specific objective gives you the time horizon and the lump-sum value that you are targeting – and a pretty good idea of how much risk you can tolerate through your choice of investment vehicle.

2. Establish how much you can put away each month. One of the biggest mistakes we make with our money is to meet our monthly financial commitments and spend the rest. But if you want to take charge of your financial life, you need to prioritise your spending, rethink your debt, and then decide how much you will save or invest each month. Many advisors recommend that you save at least 15% of your gross income. And the best way to see those savings grow is to invest them wisely.

Part of this process involves getting rid of 'bad' debt. Don't even think of investing if you haven't paid off your credit cards, store cards and personal loans. Interest charged on these debts could be well in excess of what you earn through saving or investing.

3. Decide what assets to buy. If your investment time horizon is shorter than five years, calculate how much you will have to put away monthly to get to your target. You do not have the luxury of time to make up serious investment losses, so confine yourself mainly to low-risk assets such as cash or money market funds.

But a longer-term investment period – anything from five years onwards – gives you the flexibility to buy a range of assets, including cash, funds with exposure to government and corporate bonds, listed property and shares. Shares and listed property offer the greatest inflation protection and, given a long enough investment horizon, outperform other traditional asset classes. But these rewards come at a price: over the short term, returns from the stock market could disappoint.

Especially when you are starting out, you may want to enlist the services of an experienced financial advisor to help you with these decisions, but remember that you remain responsible for researching every decision thoroughly. We'll look at various investment options later on in this chapter, and in the chapter that follows.

4. *Get started on buying shares.* Given all the fees attached to share trades, professionals recommend buying shares in lots no smaller than R15 000 to R20 000. But if this is your first foray into investing and you don't have a lump sum saved up, an affordable access point into the share market is through pooled investment vehicles such as unit trusts or ETFs.

5. *Keep it up.* To ensure that you keep up your monthly investment contributions, consider a debit order. And don't scupper your long-term investment plans by cashing it all in for a holiday or a new car. Finally, don't let market declines cause you to sell investments. Sometimes it is best to wait for the market storm to pass and to remind yourself that your investment decision is backed by thorough research.

If you have investments that are not doing well, try to understand why this is so before you get rid of them – they might be poised to grow in the years to come. If you have a unit trust, for example, you should compare it against its peers to get an idea of how it is really doing.

If you have extra money to invest, you need to plan how the extra money is going to be allocated and take steps to ensure that you stick to the plan. For example, if you are going to invest in an ETF, then sign a monthly debit order to ensure that you implement your plan. As we all know, good plans are worthless without implementation.

BASIC PRINCIPLES OF INVESTING

There are some basic principles that everyone should understand before they begin investing: diversification, risk management and asset allocation. We'll get into these principles in detail when we discuss specific investment options, but let's look briefly at them now.

Diversification

Most people believe that diversification, or combining a wide variety of investments in a single portfolio, applies only within specific asset classes. In other words, when you invest in shares, you should invest in a range of different shares. But diversification is a much broader concept than that. You can diversify across asset classes, within asset classes, and over time. It is important to diversify your investments across different asset classes because they all move at different times and for different reasons. When shares are falling due to a global economic crisis, bonds might be rising because government is cutting interest rates. Over long periods of time, a diversified portfolio of assets will provide consistent growth.

Most people don't understand the importance of diversification over time. Say you are investing in shares with a lump-sum amount. To diversify over time, the basic principle is to phase your money into the market over a period of months, rather than buying all the shares in one go. To understand why this is important, consider that those people who invested in the US stock market in the year 2000 have probably still not recovered their losses 12 years later. However, if you had invested over a 12-month period starting in June 2000, you would probably have made a healthy profit in subsequent years and you would certainly be in the money now. In the lead-up to the year 2000, the stock markets in America boomed, with shares in internet businesses doing particularly well. In March 2000, the stock markets reached their peak, with the technology index in America (NASDAQ) hitting an all-time high of 5 135.52. After the bubble burst, the index collapsed and it currently trades at approximately 3 100, more than 38% below the all-time highest level. However, the NASDAQ was at levels of 2 400 nine months before the crash and nine months thereafter – this is a difference of 50%! If you had been an investor in this index, the simple act of phasing your money into your investment over a period of months would have made a world of difference.

While the NASDAQ is an extreme example because the index consists of

technology companies, investors in the broader stock market had the same experience. The S&P 500 Index in America is made up of the 500 largest companies on the stock market. If you had invested in the S&P 500 Index six months before or after March 2000, you would have bought into the index at 30% less than the peak.

This same principle applies when investing in bad times. Just as we cannot determine when the market will peak, we also cannot determine when the market will hit bottom, so it makes sense to phase in your purchases over a period of months. Chances are you will never be exactly right in the timing of your purchases, but at least you will have some capital committed before the inevitable recovery takes place. You can't simply wait for things to get better, as this means you will be buying shares at higher prices rather than participating in – and benefiting from – the recovery.

Risk

Most investors perceive risk to be market volatility, or unpredictable ups and downs in share prices, but market volatility is really hazardous only for traders or speculators because of the limited duration of their investment horizon. If you are a long-term investor, volatility presents an opportunity for you to buy great shares at a discount while others are panicking.

I believe that the impact of inflation on your assets is a far greater risk than market volatility. This does not mean that I am not concerned about volatility, but I feel that investors focus too much attention on avoiding it. I view this type of volatility in the same way as tides in the ocean: you cannot control the tide, but you can build a boat that will rise and fall with the tide without sinking. In the context of investments, if your money cannot rise with the inflation rate, you are sinking. The best way to ensure that your assets can tolerate volatility is to ensure that you diversify your assets and that you are patient when markets fall. Inflation is a different beast: it destroys the value of your money incrementally on a daily basis, so there is no major event that alerts you to the danger. It acts like a slow poison – you will only realise the impact of inflation once it is already too late and your capital is no longer able to sustain your lifestyle.

The only safe way to beat inflation is to invest in growth assets like shares and commercial property, which are volatile by nature. People who don't understand this concept often suffer in retirement because they avoid volatility at the expense of trying to protect their wealth against inflation.

Asset allocation

Your asset allocation is how much capital you have in shares, property, cash and bonds. Every person's asset allocation will be different.

In essence, most people should have a range of 35% to 75% of their investments in shares. If you have less than 35% in shares with the balance in cash and bonds, there is little chance that your capital will outpace inflation over the long term. More than 75% invested in shares is classified as a high-risk strategy, especially if you require income from your capital. We'll look at asset allocation in more detail later on in this chapter.

WHAT YOU NEED TO KNOW ABOUT INFLATION

You certainly can't control the inflation rate, but you can structure your investments to track or beat inflation. If your capital doesn't grow at the same rate as inflation, your ability to maintain your lifestyle will decline gradually until your whole way of life has changed for the worse. And because it happens slowly, you won't realise the severity of the problem until it's too late.

For example, at current inflation rates, if you invest only in cash and live on the interest of R20 000 a month, it will take 12 years for your R20 000 to buy *half* of what it could in the first year. So the only way to beat inflation over time is to invest in assets that track or beat inflation.

All inflation-beating investments carry some market risk, but that's no reason to put your faith in cash only. If you invest all or most of your money in cash, you are guaranteeing that your capital will never keep pace with inflation. For me, this is a far greater risk than market volatility, which is what seems to bother most people.

In fact, investors who are in a position to invest capital in the markets should be hoping and praying that there's *more* volatility on the horizon. If the markets remain unsettled while the underlying companies continue to grow their profits and cash balances, the foundations will be laid for the next bull run in markets. A bull run is when investors regain their confidence and buy shares in increasing quantities, which pushes up share prices over long periods of time.

I see volatility in markets as an opportunity to buy shares in high-quality businesses at great prices and then reinvest the dividends for the next few years. When a company makes a profit, it might decide to pay some of that profit to the owners of the company (shareholders). The payment to shareholders is called a dividend, and the amount paid to each shareholder will be determined by the amount of shares he or she holds. If you can be a patient accumulator of shares during volatile times, you will be highly rewarded in years to come. The take-home message here is that market volatility is not something to be feared, but an

opportunity to beef up your inflation-beating investment strategy.

LONG-TERM INVESTING VS SHORT-TERM TRADING

One of the great debates in the investment world is around the benefits of long-term investing versus short-term trading. In the one camp you have investors like Warren Buffett as one of the champion long-termers, while George Soros is in the opposing camp – and they're both billionaires.

The track record of successful long-term investors cannot be ignored, but the argument in favour of short-term traders is far more intuitive and more easily understood by outsiders. This is especially true after a market crash, when people wonder how long-term investors remained invested when the markets were so obviously overvalued.

Trading

It is human nature to want to make money as quickly and as easily as possible. And of course, any investment method that allows you the opportunity to make returns quickly is going to be more attractive at first glance.

At its core, this is one of the strongest attractions of trading as an investment philosophy – it allows you the opportunity to make money quickly. The philosophy of a trader is easily understood: you can make money if you are able to buy an item cheaply and sell it to someone else at a higher price.

In addition, market crashes are almost always obvious with the benefit of hindsight. Using this hindsight, one could argue that any investor with a bit of savvy should have been able to anticipate the crash. This means investors could have exited the market before the crash and bought in again after the crash. Admittedly I am substantially simplifying the case for trading, but I hope this illustrates the point that, in principle, trading is straightforward and easily understood.

Traders are also able to use more complex financial instruments to profit from market crashes by 'selling short'. This means that they borrow investments from someone so that they can sell them in the hope that those investments will lose value. (This is the opposite approach of the long-term investor, who buys investments hoping they will gain value over time.) The short-seller will then buy the investments back at a lower price and return the investments back to the owner. The difference between the price at which they sold the investment and the price at which they bought them back again would be the short-seller's

profit. This is very risky because the short-seller must pay the owner a monthly fee for the investments that are borrowed, so if they go up after the short-seller has sold them, it could cost the short-seller a fortune.

There are many hundreds of ways to be a trader, but there is one theme that characterises most of them: a short time horizon. Traders are not making investments that will yield substantial returns only after three to five years. Their time frames are typically shorter than 12 months, further emphasising the point that trading allows you the opportunity to make money quickly.

This was clearly illustrated by George Soros, who made \$1.1 billion in a brief period when he bet that the British pound would be devalued once the British government realised that they could not keep their currency artificially overvalued. Soros and his investment company essentially bet US\$10 billion on this view because he sold short on the pound with US\$10 billion, and when the pound dropped he bought back the same quantity of pounds but only needed to pay US\$8.9 billion – which meant he made a profit of US\$1.1 billion.

My primary concern about trading is the number of investment decisions that a trader has to make in his or her career. Every investment decision is an opportunity to make a mistake, which is particularly true if you are under pressure to make money all the time. This pressure is compounded when you have made a few mistakes and the market is going against you. In this situation it is extremely difficult to remain rational in the face of the storm, which is why we most often read about big ‘blow-ups’ (losing all one’s money in an investment) occurring in firms that specialise in trading.

George Soros is an excellent example of this. In the 2008 financial crisis, he lost a large amount of money because his predictions were wrong. These losses were instrumental in causing him eventually to retire.

Long-term investing

This is a less intuitive method of investing, but its essence is easily grasped. Long-term investors aim to buy an investment and to hold it for an extended period until the investment reaches a specific target price, at which time it is sold. They will usually aim to hold their investments for at least three to five years, a time frame that provides fewer opportunities to make investment decisions, which is actually a good thing. Long-term investors are less likely to be influenced by short-term events that could lead them to make irrational decisions.

Longer time frames allow you to have a better perspective of events. If you only expect to sell something in the next three years, you are less likely to react

to news that might influence a share price for a three-month period. For a trader (i.e. a short-term investor), three months is the equivalent of a lifetime.

I am unashamedly a fan of long-term equity investing. A good long-term investor treats each decision to buy a share in the same way that a person decides to buy a home. You look at all the defects as well as the positive factors, with a view to keeping the investment for the next 10 or 20 years.

Long-term investors only really get rich after 10 to 15 years of investing. If they invest wisely, the chances of 'blowing up' on a long-term investment are much smaller, but traders face this risk constantly. Even if the stock market does not perform well over longer periods of time, say 10 years, a long-term investor can still make money from dividend-paying shares over this period. Dividends make up more than 50% of the total returns earned by equity investors over the long term. This is one of the reasons I prefer long-term value investors: they focus on dividends and not just the 'growth story' of a company.

Of course, trading as an investment philosophy has its merits – there are thousands of people who have made a fortune through trading. At the same time, however, there are many, many more traders who have lost everything and now work in other industries trying to make a living.

TAKING CONTROL

If you're not an investment professional, just the thought of managing your own investments may sound very stressful to you. Today you will hear an expert on the radio telling you that 'equities are cheap' and the following morning you read in the newspaper that 'equities are overvalued'. How on earth are you supposed to make an investment decision without completing a degree in finance?

The most important thing you can do is develop an investment strategy that suits you. This doesn't have to be complex, and it certainly doesn't require a doctorate in economics. All you need to do is apply common sense and do a little research.

To begin with, you need to understand what will drive the performance of your money over the long term. This starts with knowing the difference between good investments and poor investments. A good way to judge is to look at which investments have consistently managed to outperform inflation over a long period of time.

Look again at the table in the previous chapter on [p. 78](#). It shows that equities are consistently the best investment over the long term, and cash is the worst. The table also indicates that residential property is not a great investment, but it does beat inflation. But as with any investment, we can't predict how share prices will move, or when; nor can we predict how much dividend income equities will generate. In other words, there is risk associated even with long-term investing. Thus it may not make sense to have all your capital in shares if you need income *and* capital preservation, but residential property may not be your best growth asset. If you need income *and* growth, you probably need a combination of investments.

So, you need to determine the right combination of investments and decide when you should start investing. First, however, you need to be aware that market timing and the choice of individual investments will have a minimal impact on how well your money will grow over the longer term. A landmark study done in 1986 by three US academics (Brinson, Hood and Beebower) found that 93.6% of portfolio investments were determined by asset allocation. Asset allocation means the combination of cash, bonds, property and shares that you hold, and it has far more impact on your portfolio growth than the selection of the right shares or bonds. For people who are worried about their investments, this is very powerful information. It means that you don't have to worry too

much about whether the stock market is expensive or whether you should buy Anglo American instead of BHP Billiton. You need to focus on the right combination of assets.

Using an investment plan that focuses on an asset allocation that suits your objectives allows you to ignore much of the noise in the press. If your goal is high growth, you should make greater investments in shares. A goal of high income means greater exposure to bonds and listed property and a smaller exposure to shares. Once you have established your asset allocation, you don't need to monitor your investments too often – you can focus on other aspects of your life. Instead of worrying about the rand, high stock markets or interest-rate changes, you should focus on your income, expenses, assets and debt, all of which we work with every day and which should be under your control to some extent.

MANAGING YOUR RISK

Many investors don't understand risk. This was clearly illustrated during the financial crisis of 2008/09, when financial institutions and private investors alike were devastated by losses during the market crash.

Anyone trying to beat inflation will experience losses during an investment career. As any good money manager will tell you, investment risk is not a one-way street. Even if you are successful as an investor, there are times when the markets will take some of your money. The real art is to ensure that these losses are manageable and that they fall within your overall investment strategy. To achieve that, begin by asking yourself five questions:

1. *What is the term of the investment?* This is probably the most important question to be answered. If you plan to use the invested money within 12 months, don't choose shares, because of the risk that they will lose value in such a short period. If you don't know when you might need your capital, you should have a spread of investments. You can then access the cash investments first and give yourself time to sell the more risky investments if you need the money unexpectedly. This will be especially helpful during a market downturn.

2. *What is my growth objective?* Once you have established the minimum term of your investment, you need to decide what type of growth you would like. Simply put, the higher your growth objective, the greater the risk of the investment. If you want maximum capital growth and your term is five years or longer, you could invest in shares. If your term is three to five years, then you should look at bonds or a combination of shares, listed property and bonds with a greater portion in bonds.

3. *What is the benchmark for the investment?* A benchmark is the return objective that is set by the investment manager or product provider. In most instances the benchmark for investments will be an appropriate index or combination of indices. If you wanted to invest in a unit trust that invests in government bonds, the appropriate benchmark would be the All Bond Index. Alternatively, if you invested in a diversified moderate-risk unit trust, the benchmark might be 50% of the All Share Index and 50% of the All Bond Index.

It is important that you have some objective method of judging your investment performance. For example, if your investment has lost value over a year – say, a loss of 5% – you might be tempted to switch to something else that has grown over the same time period. However, before making this decision you need to establish whether your investment has, in fact, performed poorly. So, if

your investment was 100% invested in shares and therefore your benchmark is the All Share Index (which consists of all the shares in the stock market), and the whole market fell by 15% over the year, then your loss of 5% was actually very good. Remember, shares will always lose value in some years – that's the price we pay for their excellent long-term growth.

According to the Cambridge Online Dictionary, an All Share Index is a series of numbers that shows the changing average value of the share prices of all the companies on a stock exchange, and it is used as a measure of how well a market is performing. So, if you read that the JSE All Share Index is at a level of 33 975, the value of the actual number is not important. The change in value of the number is what we focus on. To illustrate, if the value of the number was 33 886 on January 1, and it is 37 275 by the end of the year, we know that the whole stock market has grown by 10% over the year. (Keep in mind that the All Share Index value is an average of all the share prices in the stock market, so the value of some shares would have increased by more than 10%, while others might have lost value over the year.)

If your investment is in bonds, then the benchmark might be the BESSA Govi Index, which is the bond equivalent of the All Share Index.

For more complex investments, a benchmark can assist in your understanding of the product. If you have a highly diversified investment that includes shares, bonds and property, you cannot use the All Share Index as your benchmark. You will need a benchmark that includes a combination of indices – *e.g.* 33% All Share Index, 33% All Bond Index and 33% SA Listed Property Index (SAPY). If someone is trying to sell you a unit trust that they promise is 'low risk' and its benchmark is to beat the All Share by 3% per year, you can be assured that the investment carries high investment risk.

4. What is the maximum loss I can tolerate? This is a more difficult question to answer and is usually the focus of risk-profile questionnaires that insurance companies love to use. If you're the type of person who won't lose sleep if your investment has lost money over the last six months, you have a tolerance for risk. If you stay awake worrying because your ETF investment is down and you could have done better with a bank deposit, then you probably have little tolerance for risk.

In any case, you need to try to understand the maximum potential loss of an investment before making a decision about where to invest your money. For example, if you want to buy shares, understand that they can lose 50% of their value in a big crash and may take a number of years to recover. If you know that a 50% loss is likely to send you over the edge, perhaps you should limit your investment in shares.

5. *Do you understand the investment?* Don't be afraid to ask 'dumb questions', because these are usually the ones that will save you. Warren Buffett freely admits that he doesn't understand IT companies, even though they are some of the greatest shares to own. As a result he simply doesn't invest money in them. Instead, he finds other businesses that he does understand. This strategy seems to have worked well for him over the last 60 years and is worth emulating.

You should also always follow the 'too good to be true' rule. If an investment guarantees you 20% per year for the next five years, you can assume it's a scam. And don't assume that it's not a scam just because a large bank is offering the product. Many large banks have been investors in scams on behalf of their clients.

I'm not going to kid you – it is difficult to make good investment decisions. However, it's not too difficult to avoid the really poor ones. Do your homework before making a decision and ask all the questions you have. You will never regret knowing more about your own investments, whereas you might regret knowing too little.

Phasing in to manage risk

A lot of research shows that a dramatic loss in the early stages of your investment's life can have a severe impact on its potential returns. This is especially true if you are recently retired and take the decision to invest 100% of your capital immediately into your desired portfolio.

I recently met John F., a retiree, who invested all the money in his living annuity into a diversified portfolio in March 2008. He had a good start to his investment performance, but then the market crashed in late 2008 and caused a 20% loss in his portfolio. During the market crash, he still needed to draw his income and inflation was eroding the value of his money. This combination of events resulted in long-term losses to his capital from which he is unlikely to recover unless the stock markets jump significantly in the next few years.

In contrast, when I met Sue W. in early 2008, I advised her to phase in her retirement fund over 12 months. She experienced no losses in the first 12 months of her retirement, although her growth was minimal over the first year. The effect of this phasing-in strategy meant that she was buying investments during the entire market crash of late 2008 and early 2009. The fact that her capital was being slowly invested into the markets during a very rocky time gave her some comfort, which meant a low-stress first year of retirement. Her portfolio has subsequently grown by more than 11% per year when the inflation rate has been 6%. This impressive growth is largely due to the low prices she initially paid for

her investments.

Phasing in has a cost

Vanguard published a report in July 2012 called ‘Dollar cost averaging just means taking risk later’, which looked at the long-term impact of phasing your lump-sum investments into the market over many different periods. They showed that when an investment is immediately invested into the desired portfolio (lump sum), there is a 66% chance that it will outperform a portfolio that is phased in over 12 months. This applies to balanced portfolios, 100% equity portfolios and 100% bond portfolios in the US, UK and Australian markets.

Most gamblers would tell you that betting your money on something that has a 66% chance of winning is considered a low-risk bet. I would agree with them. For experienced investors who don’t need to access their capital for at least five years, it makes sense to invest all your money at once, especially if you invest in a diversified portfolio of assets. You will get a slighter better return in most market conditions. This is especially true if you invest in a rising market.

It’s important to note, however, that none of us can predict what the market will do in future, so you can’t rely on the fact that the market has recently climbed as an indication that it will continue to do so. If you are investing during a declining market, it is very likely that phasing in will work in your favour.

What to do with your lump sums

If you are investing in extremely volatile stock-market conditions or if you are not an experienced investor, it is advisable to phase your lump sum into your preferred investment portfolio over 12 months. There is little benefit in doing this over longer periods. If you phase in your retirement fund and the market rises, you won’t lose capital, but you will lose out on some growth.

Conversely, if the market crashes during the phase-in period, you will limit your initial losses dramatically. This has the benefit of being emotionally less stressful and enabling you to buy great assets at a discount to their fair price. In addition, you will be less tempted to sell your investments and remain in cash until ‘things get better’. This will be hugely beneficial to you over your lifetime.

ALLOCATING YOUR ASSETS

Asset allocation is simply the decision about how much of your money should be invested in each of the assets of your portfolio: shares, property, cash and bonds. Your personal asset allocation is the most important factor in determining your long-term success as an investor and should be the guide for all your future investment decisions.

There are many complex financial models that can be used to determine your specific asset allocation, but they all revolve around three basic factors: how long you plan to invest for (investment term), how hard your money has to work (required growth) and your emotional ability to tolerate losses (risk tolerance).

In my opinion, everyone should have some investment in shares, and I think I'm backed up by historical fact. From the year 1900 to 2012, shares have been the best-performing asset class and have beaten inflation by 7.5% per year. Unfortunately, shares are also the most volatile investments over the short term and cause investors the most consternation. But they still give you the best inflation protection, and to get that, you need a minimum of 35% invested in shares.

If this is the minimum allocation, then how do you determine what to do with the rest of your capital? Start by considering those three basic factors listed above: investment term, required growth and risk tolerance.

Investment term

If you are saving for a long-term goal, *i.e.* more than seven years, and you don't need income from your investment, you can comfortably invest 75% of your capital in shares. The balance can be in cash for emergencies.

If you are saving for a short time, *i.e.* three years or less, you should have no money in shares and all your money in cash. If you are saving for five to seven years, you could have half in shares, 25% in bonds/listed property and 25% in cash. This is also a good allocation for a long-term income-generating portfolio.

Required growth

If you are young and need maximum capital growth, you should have most of your money in shares and listed property. Conversely, if you are elderly and in financial difficulty, you might require significant capital growth, but you can't afford to lose any money. This means you should have limited capital in shares, with the bulk in government bonds and cash. Most people need maximum

capital growth, which means a long-term allocation of 75% in shares.

Risk tolerance

Most of us should have an allocation to shares ranging from 35% to 75%. If you are reasonably risk tolerant, require some capital growth and might need some income in the near future, your allocation should be 55% in shares, 25% in listed property/bonds and 20% in cash. If you aren't very risk tolerant, rather consider a ratio of 35% in shares, 35% in listed property/bonds and 30% in cash.

Putting together the perfect portfolio

Here are some tips for putting together a diversified portfolio for various financial objectives:

- Listed property and shares (equities) are an ideal combination for long-term capital growth.
- Bonds can also be included in a portfolio as a stable, inflation-beating asset.
- If you are reasonably young and looking to grow your assets without an immediate requirement for income, you could combine an investment in shares with listed property. A good allocation would be 75% in shares and 25% in property.
- If you are looking for a combination of capital growth and income, you could reduce your allocation to shares, *i.e.* 50% in equities, 25% in bonds and 25% in property. This combination should ensure that your capital grows more than the inflation rate while generating a good income. If you are not built to cope with the volatility of the stock market, you could reduce your investment in shares to 35%, increase your investment in bonds to 40% and keep your property investment at 25%.

The easiest and probably most cost-effective way of creating a diversified portfolio would be to invest in ETFs. As mentioned earlier, an ETF is an investment that tracks an investment index (e.g. the All Share Index), commodity (e.g. gold) or other baskets of assets. It operates like a unit trust, but it trades on the stock market like any normal share. Look for diversified ETFs, and enquire about how much you're being charged to have them managed before you make a decision – you can go to [page 120](#) in the next chapter for further details. Your ETFs should give you the necessary equity and bond exposure, and you can then add your property exposure via a property ETF or buy individual property shares.

Another option is to create your ideal portfolio simply by using a stockbroking

account. The costs of creating and maintaining the portfolio would be quite low (initial brokerage plus a monthly portfolio fee). When you have a stockbroking account, you will normally pay a fixed monthly fee, *e.g.* R45 per month. In addition, when you buy or sell a share, you will pay a fee that is normally a percentage, *e.g.* 1.5% + VAT of the value of your transaction. So, if you bought R10 000 worth of Anglo American shares, your transaction fee would be R171. There are many stockbrokers, but I like Standard Bank, FNB and PSG Online's stockbroking services for individuals. You can open your accounts online with them and their investor education is very good. In addition, their pricing is very competitive.

GOLD AS AN ASSET CLASS

For centuries people have used gold as the ultimate hedge against unforeseen risks. In times of political upheaval, economic collapse or war, wealthy families used gold as their primary method of storing and transporting their wealth.

This changed only in the last half of the 20th century, when countries started issuing currency that was not underpinned by gold, eventually causing gold to be replaced by the US dollar as the ultimate hedge against unmanageable risks. This worked very well for more than 30 years, until the early 2000s, when a series of financial shocks around the world culminated in the global financial crisis in 2008/09. This crisis taught the world that the whole financial system was not as secure as we thought and that the US dollar was also vulnerable, and led to a resurgence in the value of gold, which had been in steady decline since the early 1980s. New investment instruments, such as gold ETFs and a relaxation in the laws governing ownership of physical gold in South Africa, have made it a popular asset class again.

Unfortunately, gold is a complex asset class to analyse, because its price is largely determined by fear. If the world is in financial difficulty and people are very worried about the future, they will buy gold at any price to protect themselves against financial ruin. However, if the economy stabilises and people regain confidence in their financial well-being, the price of gold will plummet.

According to J.P. Morgan, the price of gold has grown by only 2% per year from 1900 to June 2012. By comparison, shares have grown by 7.5% per year above inflation during the same period – despite all the troubles in stock markets over that time.

Unlike companies or properties that are able to generate income while you own them, gold is a dead asset. If the price is declining, you have no income to offset the cost of holding the asset. This means that you should view gold as a form of insurance: it can form a small part of your overall portfolio, but you should not expect it to generate the bulk of your capital growth over your lifetime.

In fact, unless you are very wealthy and have more capital than you require, I wouldn't suggest holding gold as a permanent part of your assets. It would be better to invest in large mining houses that own a range of mines. If the price of gold starts to rise because of economic uncertainty, mining house shares will also increase in value. If the price of gold declines again, one hopes that the management of the mining companies will still generate profits from their other

mines (e.g. copper, steel, etc.).

For very wealthy families or large retirement funds, it makes sense to hold a small percentage of gold. The ideal allocation to gold would range between 2% and 5% over the long term. In times of great uncertainty or financial disaster, your gold can be used as currency to buy assets that others are desperate to sell.

For those who live in politically unstable countries, gold might make up a larger portion of their portfolio because they cannot rely on the value of their land as a hedge against financial instability. The collapse of Zimbabwe's economy proved that land ownership is not a good store of wealth in desperate times.

I would certainly not recommend gold as a preferred asset class for trading or speculating. It is so unpredictable that you could buy gold with a view to selling it at a profit in a few months and be left holding it years later because the price collapsed soon after you bought it. This happened to those who bought gold in the early 1980s and watched the price halve in a period of months. In that situation, you will either sell at a massive loss or be forced to hold it, hoping for a recovery in the price.

INVESTING OFFSHORE

Many top fund managers and market commentators urge South Africans to invest more money overseas because the offshore markets are ‘cheaper’ and therefore offer potentially better returns than the JSE.

Of course, some offshore markets are cheap, but this doesn’t mean the returns for South African investors are necessarily good. South Africa’s stock market has been one of the very best for achieving real (inflation-beating) growth over long periods of time – far better than the offshore ones being punted by the experts.

Therefore, if you are looking for the best possible investment growth above inflation, the JSE is a good place to invest. Since 1900, the JSE has beaten inflation by a larger amount than the US, European and global stock markets. In fact, only Australia has proved more rewarding for investors, and this was by only a very small margin. As shown in the table below, South African shares have grown by an average of 12.5% over the long term. If you take out the effect of inflation, then South African shares have grown by 7.2% per year above inflation since 1900.

Stock-market growth from 1900 to 2011 for South Africa, USA, Europe and the world

	Nominal growth	Real growth per year
South Africa	12.5%	7.2%

USA	9.3%	6.2%
Europe	7.7%	4.6%
World	8.5%	5.4%

Source: Elroy Dimson, Paul Marsh and Mike Staunton, *Credit Suisse Global Investment Returns Yearbook 2012* (Zurich: Credit Suisse Research Institute, 2012).

Despite our country's very difficult history, South Africa has proved to be a great investment destination, even in hard-currency terms. According to Investec, in the 10 years to June 2011, if you had invested R100 in the JSE, you would have grown your capital to R400, while your R100 invested in the global stock markets would have been worth R94. All equity unit trusts in South Africa that invest overseas grew by an average of 0.3% per year in the 10 years to February 2012, while over the same period South African equity unit trusts have grown an average of 16.9% per year.

This is the context to remember when you hear market commentators urging you to invest overseas because offshore shares are cheap. I think it makes sense to judge your growth in rands if you are planning to spend your capital in South Africa. I differ dramatically here from local fund managers, who look only at the relative 'cheapness' of our market versus the international markets. When the international markets perform well, the rand strengthens, which erodes your stock-market growth when you calculate it in rands. In my experience, and as the unit-trust numbers show, the rand usually neutralises the growth of the international stock markets.

When does global investing make sense?

There are some good reasons to invest money overseas, as it always makes sense to have diversification in your portfolio. Global shares, bonds and property do grow at different times relative to South African assets, and your overall growth will be better with a limited amount of overseas investments (e.g. 15% to 25% of your portfolio).

In addition, you can benefit from the rand depreciation when it occurs via a currency investment. This means that you might consider investing a portion of your money directly into another currency. For example, you could buy a US dollar money market unit trust with 65% of your overseas money, with the

remaining 35% put into international shares. If the rand starts to weaken, you will benefit, because your US dollars will be worth more rands over time. The investment in shares is there to ensure that your capital does not lose pace with inflation.

If you are planning to live overseas or are concerned about how your capital will be taxed in South Africa, then it might be wise to invest a greater amount offshore. I certainly wouldn't make a long-term commitment to offshore shares simply because they are currently cheap.

How to invest offshore

We are spoilt for choice when it comes to investment options, and the right choice of investment should be determined by your preferences and objectives. If you are not worried about a Zimbabwe-type deterioration of the South African economy, then rand-based overseas investments might be ideal for you.

For example, you can buy foreign-market ETFs on the JSE, where you invest in global markets for the cost of a share trade plus a small annual cost. Alternatively, you can invest in JSE-listed companies that operate overseas. Companies such as Richemont, British American Tobacco (BAT), South African Breweries (SAB), Grindrod, BHP Billiton and a host of others make a large proportion of their money overseas.

There are also many rand-denominated offshore unit trusts. While these are convenient, I still prefer the local ETF route. If you are concerned about the long-term future of South Africa, then you can invest directly overseas via your offshore allowance. You will not be required to bring this money back to South Africa, but you are liable for income tax on interest and dividends, as well as capital gains tax, when you trade the investments. This is not really my preferred route, however, as I think it is expensive to buy foreign currency, and many offshore unit trusts are more expensive than local funds.

FORECASTS: HOW TO INTERPRET THEM

We all love a good prediction, whether it is about sport results, the end of the world or the price of gold. If you can make an accurate prediction about something significant, you will get people to listen to you. But surely we know by now that predictions are generally pretty worthless things? No one can accurately predict what the future will hold.

In the investing world, predictions are known as forecasting, and you should follow them only for their entertainment value, not as real investment advice.

Most experts have horrific accuracy rates when it comes to forecasting, and many people lose a lot of money as a result. Studies of the predictions of share analysts, economists and commodity analysts have shown that they are wrong more than 50% of the time, which makes their predictions worthless.

Unfortunately, economics is a flawed academic discipline. Economists can't even predict interest rates with any real accuracy. So by all means listen to the experts, but do your own research and don't base your decisions on forecasts – you have only a 50/50 chance of getting it right if you do, which hardly seems worth it.

9

Investment Options

In the previous chapters we covered a range of different types of investments and how you can put them together to create your own unique mix of assets to suit your long-term financial objectives. This chapter aims to provide an explanation of the different investments that are covered in the book. I have listed them alphabetically and, where possible, I have indicated the advantages that the investment offers.

BONDS

A bond is a debt investment in which an investor loans money to an entity (corporate or governmental) that borrows the funds for a defined period of time at a fixed interest rate. Bonds are used by companies, municipalities, states and governments to finance a variety of projects and activities.

Just as your home loan is also referred to as a bond – because you owe money to the bank over a fixed term – a bond is an investment in which you, the investor, lend money to either a company or a government entity for a defined period of time at a fixed interest rate.

Interest on bonds is usually paid every six months, and the interest rate is normally determined by two main criteria: the credit quality of the entity that issues the bond, and the bond's lifespan, which can extend to 30 years. Here is an example of one of the bonds issued by government through the Treasury:

<i>Name:</i>	R186
<i>Date issued:</i>	21/05/1998
<i>Interest rate:</i>	10.5% per year
<i>Interest payment dates:</i>	21 June and 21 December
<i>Date of maturity:</i>	21 December 2025, 2026 and 2027

The major difference between bonds and shares is that shareholders own a part of the company, while a bond holder is simply owed money by the company or government entity. Shares have an indefinite lifespan, while bonds have a defined lifespan.

Bonds that are issued by financially sound governments or corporates can be a great source of income for retirees. Most bonds will track or even slightly outperform inflation with their income. And because bonds yield returns in a completely different way to shares, they represent a diversifying element in any portfolio.

Bonds generally trade in very large denominations (usually a minimum of R1 million per transaction), so they are not readily accessible as direct investments to private investors. Your best way to buy a bond would be through a unit trust or an exchange-traded fund (ETF). Note, too, that the interest generated by South African bonds is taxable.

DIVIDENDS

When a company makes a profit, it might decide to pay some of that profit to the owners of the company (shareholders). The payment to shareholders is called a dividend, and the amount paid to each shareholder will be determined by the amount of shares that owner holds. Dividends are usually paid in cash, but sometimes shareholders are offered shares to the same value as the cash instead. Dividends do attract tax, but they are much more tax-efficient than interest. Over time, your dividends can increase in value if the company does well and profits go up.

ENDOWMENTS

In an endowment, you invest money via a lump sum or monthly debit order for a minimum of five years or longer. Endowments have a fixed contract when you start the investment, so there are specific rules that regulate changes to your monthly payments or lump-sum additions. The money that you then take out of the endowment when it matures is tax-free for the investor. This is because the endowment itself pays income tax and capital gains tax. Capital gains tax is paid when you have made a profit on an investment. A portion of the profit (gain) will be added to your income for the year and taxed accordingly.

Endowments are often marketed as education funds, but essentially they are an enforced way of saving a certain amount of money every month for a fixed period. It is important to remember that endowments can hold a range of different investments, including shares, bonds, unit trusts and property. You need to make sure that you understand the underlying investments of the endowment so that you are in the appropriate investment for your requirements.

For trusts and income earners who are at the maximum income tax rate, endowments can be a tax-efficient way of saving. The income tax and capital gains tax inside the endowment are lower than the maximum rates that individuals pay and lower than the rate that trusts pay. For people who are at an income tax rate of 30% or more, investing in an endowment might make sense.

Endowments can be expensive when sold by a life assurance company or bank, because they will typically charge you an upfront fee and a high annual fee. I prefer endowments that are offered by unit-trust companies, because there is usually no cost associated with them. It's important to keep in mind that endowments are a five-year product, which means that you might have problems if you need your money within the first five years. Your capital will only be tax-free if you have invested the money for five years or longer.

EXCHANGE-TRADED FUNDS (ETFs)

Exchange-traded funds trade on the stock market like an ordinary share, but they consist of a basket of investments – *e.g.* shares, bonds or property. ETFs generally charge very low annual fees and no upfront fees, which makes them ideal for private investors who want to invest in shares either with a lump sum or debit order.

Most ETFs are based on an index, or a portfolio of securities representing a

particular market as a whole or a particular market sector. For example, the oldest ETF in South Africa is the Satrix 40, which tracks the JSE's Top 40 companies. The JSE Top 40 is made up of the 40 largest companies on the stock market, but instead of buying shares in each company individually, you buy one ETF that owns shares in all of them.

I am a big fan of indexed ETFs. A low-cost ETF that owns a diversified selection of shares is the best option for anyone with limited resources but who can afford to put a regular amount of money each month into an investment. You can buy your ETF directly or via a stockbroker. ETFs are usually much cheaper than life assurance company investments and are often cheaper than unit trusts too.

There are an increasing number of ETFs and other indexed products being launched, and many of them are becoming more exotic and difficult to understand. The more complex products are called exchange-traded notes (ETNs) and should be avoided by investors who are not financially astute. New investors are advised to stick to the KIS principle with ETFs: 'Keep it simple!' It is the nature of product providers to try to sell 'newer, better, fancier' products all the time to beat their competitors. The fact that they need to sell products does not mean that you should buy them. And remember that few fund managers are consistently able to outperform indexes.

FIXED DEPOSITS

A fixed deposit is a kind of savings account that usually pays a fixed rate of interest for a fixed time period. As the name suggests, you make a deposit of a fixed amount and then leave the funds to mature and gather interest until the maturity date arrives.

Funds placed in a fixed deposit usually can't be withdrawn prior to maturity, although there are some banks that have slight variations on this rule. Sometimes funds can be withdrawn if you give advance notice, but you might incur a penalty for this.

Fixed deposits are relatively safe investments when provided by financial institutions such as banks, savings and loan corporations, and credit unions that are properly registered and regulated. And because your interest rate and term are guaranteed by the bank, there will be no surprises with this investment. That said, fixed deposits are not my favourite investments – although they are low risk, they also yield low returns. You should use them only if you need to keep your money in cash for a specific purpose.

I don't like long-term fixed deposits – *i.e.* longer than three years – as these rarely do better than inflation and you can get better growth from other low-risk investments. If you need to fix your money for two to three years, consider investing in RSA Retail Bonds, discussed later in this chapter. These bonds are guaranteed by government and generally offer the best interest rates to individuals.

HOME LOANS

A home loan, mortgage or bond, in common parlance, is simply a loan from a bank or other financial institution that assists people in buying their own homes. The bank will lend you money to buy a house conditional on your credit record, your ability to afford the repayments, and finding sufficient value in the home in question to secure the loan. Interest is payable on your home loan, and the amount is usually loaned over a set period, such as 15 to 30 years. You will be required to pay back an instalment on that loan every month for the full period of the loan.

Provided your monthly repayments are affordable, this is the only way most South Africans can afford to buy their homes. But far too many people buy homes that are too expensive, which means they use all their spare income to repay their mortgages when they should also be investing some of their money. Be sure to factor in the additional costs – rates, insurance, maintenance costs, and so forth – when you purchase a home.

Paying back extra money into your bond each month will both reduce the amount of interest you pay over the period of the home loan and bring down the repayment amount. Always try to pay off your mortgage within 10 to 15 years.

For people who are very financially disciplined, a home loan can also be a source of low-cost finance for other assets. Some people use their home loan as a credit facility to buy cars or to purchase growth assets such as shares. This can be a very efficient way of using debt at good interest rates; however, this is also a very easy way to fall into an even bigger debt trap. I have met many people who have used their home loans to finance expensive vehicles and have then taken six or seven years to pay off the vehicle. In addition, they have bought lifestyle items such as jewellery, furniture and appliances. This is wealth destruction at its best. If you are going to use your home loan as a single debt facility, then make sure you pay off your purchases within the time frame of the original debt. So, if you were to buy a car using a normal vehicle-debt facility, you would pay off the car within 54 or 60 months. If you are using your home loan, ensure that you pay off the car within the same time frame.

INDEX INVESTING

Index investors try to get the same return as generated by a specific index. Most of these indices are based on shares, bonds or listed property. In South Africa, the most discussed indices are the JSE All Share Index and the JSE Top 40 Index. As the name implies, the All Share Index consists of all the shares listed on the stock market, while the Top 40 is limited to the 40 largest shares on the JSE. If you would like to invest in the index, you would normally make use of a unit trust or ETF that follows a specific index. The index is normally quoted as a number – for example, ‘The All Share Index reached 37 213 today’. This is simply a ‘value’ of all the shares on the stock market and is meaningful only in that it explains whether the stock market as a whole has gone up or down over a specific period (over one day, week, month, year, etc.).

History has proved that it is very difficult for most investors to beat their index over long periods of time. When you invest in a fund or other product that aims to beat an index, there is a management cost, a transaction cost and other charges that have to be recouped regularly. Moreover, most investors are simply wrong in their investment decisions more often than they are right.

This means that more than eight out of every 10 unit trusts in South Africa have not been able to beat their index over 10-year periods. There are a handful of great money managers who have beaten the index over the long term – Warren Buffett is one of them – but there are not many of them and you tend to find out about them only after they have reached their peak as investors.

By far the best decision that most investors can make is to invest in indexed, low-cost investments. Over the long term, you will be better off than most fund managers more than 80% of the time. There is little need for you to do anything or manage anything, as the investment is very passive in nature. You should be prepared to leave your money in the index for seven to 10 years at least without making changes.

When the investment markets are especially irrational, a particular index might shoot up too quickly or drop too fast as the result of a bubble. When investing in share indices, I prefer a more structured index that can reduce the effects of these bubbles. For example, when investing in the Top 40 Index, I prefer investing in an ETF that allocates equal amounts of money to each share in the Top 40. So, for every R100 invested in the Top 40, R2.50 will be allocated to each share. This is known as an equally weighted ETF.

JOHANNESBURG STOCK EXCHANGE

The JSE is the South African stock market where all listed shares and other investments are bought and sold. The JSE is highly regulated and all transactions are concluded electronically. Most private investors will trade their shares via their stockbroker.

LISTED PROPERTY

Listed property refers to property companies whose shares are traded on the stock exchange. These companies generally own a variety of office blocks, industrial buildings and shopping malls.

Some listed property companies manage their properties, while others simply own the buildings but outsource the management to property managers. These companies often make use of debt to buy buildings so that you get an element of gearing in your investment. This means that for every R100 that the company owns, it might borrow another R60 when buying properties. If the value of the property increases by 10%, the company will have a R16 profit because of the gearing. Without gearing, the property would have generated only R10 in profit.

For investors who prefer property to normal shares, this should be your investment of choice. South Africa has a fantastic selection of well-managed listed property companies that have rewarded their investors for decades. I tend to recommend listed property in conjunction with bonds to investors who require inflation-beating income and diversification.

Property companies are extremely sensitive to interest-rate fluctuations, which results in their prices skyrocketing when interest rates are low. This can cause bubbles in their share prices. In addition, there is always a risk that the managers might borrow too much and place the company in jeopardy. With the larger listed companies, this is less of a risk. The income that these companies generate is fully taxable as income and not as dividends.

Many people are fans of buying residential property with debt from the bank and renting it out as a way of creating wealth – another form of gearing. When I discuss listed property with them, they tend to respond by pointing out that you cannot borrow money to invest in these businesses, but they are mistaken.

First, listed property companies are already geared. Second, if you own some listed property, banks will use this as surety to lend you more money. For example, if you have R500 000 already invested in listed property, most banks will lend you another R250 000, which you can use to invest in more listed property. This strategy works because you get income from listed property that can be used to offset some of your interest repayments. In addition, your property investment is widely diversified across a range of areas, industries and property types.

LIVING ANNUITIES

When you retire, a living annuity is a tax-efficient, flexible way for you to manage your pension income from an employer's retirement fund, a retirement annuity or a preservation fund. Essentially, you make a lump-sum investment of your retirement funds into a living annuity, and then you draw an income from that investment.

These are highly transparent, flexible investments that are ideal for wealthier individuals. There are very low-cost living annuities available from unit-trust companies that allow you to manage your retirement capital properly. All the capital invested inside the living annuity attracts no income or capital gains tax, but you must pay tax on the amount withdrawn. In addition, you can nominate beneficiaries on your living annuity so that when you die the money goes to them.

As there is a lot of flexibility with these investments, people often make incorrect investment decisions with their capital (they take either too much or too little risk). In addition, because you are allowed to withdraw up to 17.5% of your capital every year as income, some people erode their living annuities too quickly after retirement and are left in financial difficulty.

Living annuities are my preferred retirement investments for well-off individuals. Like all good things in life, you need to treat them carefully to ensure that you get the most from them. Try to draw no more than 8% of your capital every year as income. If you withdraw any more than this, chances are you will erode your capital too quickly and run out before you die.

MONEY MARKET ACCOUNTS

A money market account is an account at a bank that pays a higher interest rate than other savings vehicles usually offered by banks. In exchange, you are required to keep a fairly high minimum balance in the account, and there are also restrictions on how many transactions you can make through the account per month. In essence, a money market account is a savings account with terms and conditions, and better interest rates.

The interest rates for money market accounts are normally higher than for other very low-risk investments, and there are generally no obligations to invest your money for fixed periods. Because the funds are readily available, I like to use money market accounts for my emergency cash fund. But as with all cash investments, this is not a good place to keep your money for the long term, unless it is your emergency fund. The interest earned will generally not beat inflation over time.

Watch out for banks that charge initial fees on money market accounts. One of South Africa's big banks charges you 0.4% of the value of your deposit every time you put money into your money market fund. This is an additional cost to their annual fee, which seems very unfair to investors.

OFFSHORE INVESTMENTS

South Africans tend to view offshore investments as a separate asset class to their local investments. I think this is a mistake. You should view your whole portfolio as one entity. For example, if all your investments are worth R1 million, irrespective of where your money is invested, you need to know how much of the R1 million is in shares. It does not matter if the shares are listed in South Africa, London or New York – they are still shares.

As a general guide, I would say that for proper portfolio diversification, we need a minimum of 20% to 30% of our money invested overseas. Just remember that a large number of our biggest companies earn their money overseas. For example, SAB, Remgro, Anglo American, BHP Billiton and many more companies earn more from outside the country than from South Africa. This means that you already have a lot of overseas exposure if you have a retirement fund or general equity unit trust.

Very wealthy individuals (R50 million or more) should allocate a greater portion of their investment capital overseas. This is because they need to spread their assets across a wider variety of countries and asset classes to preserve their capital against as many risks as possible. These investors have less of a need to generate income from all investments and less of a need to get maximum capital growth.

RETIREMENT ANNUITIES (RAs)

A retirement annuity is a personal pension fund. Essentially, you put away a certain amount of money each month in an RA. Then, when the RA matures at retirement age, it will pay you out either a lump sum, a monthly pension or a combination of the two. Your monthly pension can be paid in the form of a living annuity or a fixed pension.

In addition, SARS gives you some tax incentives to place money in an RA, which means that a portion of every rand invested is subsidised by SARS. In addition, there is no income or capital gains tax on the capital inside the RA. When the income is paid to you at retirement (after age 55), the product provider deducts income tax on your behalf (the amount of tax depends on the amount paid to you).

RAs are highly regulated investments. The tax incentives offered by SARS are extremely attractive and make these a compelling investment. If you select an

RA offered by a unit-trust company, you can find very low-cost options that will reward you over the long term. If you own your own company, your RA is protected by law from your creditors. In addition, if you nominate a beneficiary on your RA, the money will go directly to that person without incurring estate duty or executor's fees.

Because the investments are highly regulated, you cannot invest 100% of your capital in shares; you need a portion in cash, bonds and property. In addition, it is impossible to get the money before you reach age 55, and even then you cannot get 100% of the money immediately. A portion, usually two-thirds of the money, will need to be invested in an annuity.

Some RAs (mostly those offered by life assurance companies) are very expensive and not transparent. I would avoid all life assurance company RAs as a general rule. Every individual who earns a taxable income should make use of the incentives from SARS to invest in an RA. Investors can buy RAs from most of the large unit-trust companies who offer their own RAs to private individuals. Normally the fees associated with these RAs will be quite low (up to 1.75% per year of the value of the capital) because the cost is subsidised by the unit-trust company.

Tax on investment income

Retirement funds pay no tax on interest or rental income. By comparison, individual investors could be taxed between 18% and 40% on investment income such as interest, rental income and trading income. This makes RAs quite attractive to investors who earn a significant portion of their returns via cash and bond investments.

Capital gains tax (CGT) and dividends tax

The introduction of capital gains tax and dividend withholding tax has made it even more beneficial to invest in an RA, as normal (discretionary) investments create CGT and dividends tax for individuals, which is not the case with RAs. There are some exceptions, such as endowments, but these use after-tax money and not before-tax money.

Protection from creditors

RAs are protected by law from creditors. This may not seem like an important benefit, but for entrepreneurs who run the risk of being sequestrated, they will have the security of knowing that their retirement capital is safe if all else fails. This protection would obviously not apply in cases where the person knows he

or she is about to be sequestered and invests in the RA only to protect the capital.

RSA RETAIL SAVINGS BONDS

These investments are very similar to fixed-deposit accounts (discussed earlier in this chapter). You make an investment, at no cost, for a fixed time period. The investment is guaranteed by the government and so is your interest that the bonds pay. There are a few different types of these bonds; I prefer those with the shortest time frame (usually two years) with the guaranteed interest rate.

SAVINGS ACCOUNTS

A savings account is the simplest way to save, apart from putting your money in a piggy bank or hiding it under the mattress, neither of which will earn you any interest. A savings account is a simple deposit held at a bank or other financial institution, and it usually provides a modest (that's putting it politely) interest rate. You usually can't write cheques from a savings account, and the account might have a limited number of free transactions.

Savings account funds are highly liquid, which means it's usually quite easy for you to withdraw cash from them. And they can be useful to hold funds that you don't intend to use for your daily expenses. But they usually pay minuscule interest, so don't expect your money to grow very fast. This makes them a poor long-term investment. Where possible, try not to keep your money in a savings account. You're better off with a money market account.

SHARES

A share is the smallest unit of ownership in a company. You can own shares in private companies as well as in companies that trade on the stock market. Investors often refer to shares as 'equities', as the terms are interchangeable.

When a company initially lists on the stock market, it sells shares to investors as a way of raising money (capital). The income that a shareholder earns from owning a share is called a dividend. Companies are not obliged to pay dividends, but most of the larger, established listed companies do pay dividends to shareholders when profits allow, usually on a six-monthly basis.

If you want to buy or sell shares in a private company, you will need to arrange your own transaction, whereas the trading of shares in a listed company is done on the stock exchange via a stockbroker. Most private investors will own shares through a unit trust, retirement fund or ETF, or directly via a stockbroker.

You will have gathered by now that I think shares are the best possible investment. Since 1900, shares have given South African investors growth on their capital that has beaten inflation by an average of 7.5% per year. The dividend income from a share is much more tax efficient than interest income, because dividends tax is lower than income tax and dividends generally grow more quickly than inflation.

Shares are volatile (their prices go up and down), subject as they are to the vagaries of the emotional tide that affects investors around the world. Many fortunes have been created and destroyed by those who think they are more intelligent than the market. Uninformed or lazy investors who do not do their homework when buying individual shares are likely to lose money.

Every investor should have a portion of his or her capital in shares (at least 35%, to a maximum of 100% if you are very young). You do not need to invest in them directly; ETFs and unit trusts are also great vehicles for investing in shares.

Keep in mind that over the long term, more than 50% of the return generated by shares on the stock market is the reinvestment of dividends. If you do not reinvest your dividends, you will severely limit your potential capital growth.

UNIT TRUSTS

Unit trusts are also known as collective investment schemes (CISs) or mutual funds. They are open-ended investments – that is, they have no set limit, either in time or amount invested – which are operated by an investment company. Each investor in the unit trust is called a unit holder, and the investors are the only owners of the unit trust. There is a wide range of unit trusts available, representing a variety of assets: shares, bonds, property, cash, gold and indexed investments.

In South Africa, unit trusts are highly regulated, very transparent investments, and a much better alternative to life assurance investments. If something happens to the company managing the unit trust, it will not affect the assets of the investors. Because unit trusts are transparent, you can find out exactly how much money you have invested in the fund and how it is invested every day. There are some very low-cost unit trusts that are ideal for most investors, and unit trusts in general are by far my preferred investment for individuals of all shapes and sizes.

Be aware that some unit trusts are ridiculously expensive. Some unscrupulous asset managers charge unfair performance fees that enrich themselves at the cost of their clients. In addition, some unit trusts invest in other unit trusts – an investment strategy called fund of funds (FOFs) – and their costs can also be exorbitant.

Try to invest in unit trusts that are operated by specialist investment companies. In my experience there are very few quality unit trusts offered by life assurance companies. Always track your costs and ensure that you do not pay more than 1.5% as an upfront fee and 2% per year as a total management fee.

10

Insurance

While insurance is not my favourite aspect of financial planning, it does play an important role in our lives. Unless you are one of the very few, ultra-wealthy people in the world, you will need some form of insurance. Most of us need insurance to protect us and our families from financial harm in the event that we experience a loss. Potential losses are wide-ranging and include the loss of property (e.g. a stolen vehicle), the loss of work (through illness or disability), or the loss of life of a breadwinner. The basic premise of this insurance is that many people will pay a monthly premium into a pool, and when one individual has a claim, that claim is paid out from the pool.

Very few people are in the financial position where they can afford to pay for the loss of a vehicle if theirs is stolen, especially if the vehicle is financed. Even fewer people can afford to pay private medical costs for a loved one who has been in an accident and needs an emergency operation. There are many more examples, but these are the types of events that insurance can protect you against.

The current problems of complex one-sided life assurance policies will hopefully change over time as regulators enforce the concept of ‘treating customers fairly’ (TCF), which will soon become part of all financial regulation. Once in place, the TCF principle will force financial institutions to treat their clients in a more equitable fashion. It will no longer be good enough for a company to draft complex contracts that are correct in terms of law but unfair to their clients. In future, financial companies will have to ensure that the contract is fair to all parties. This will provide further protection from complex investments and insurance products. In South Africa we are waiting for the government to provide clarity on TCF, but the concept has taken root to great effect in the UK and Australia. In addition, we should all ensure that we keep the life assurance companies on their toes and move our business to those companies who have a proven track record of treating their clients fairly and honestly.

AN APPROACH TO INSURANCE COVERAGE

Risk cover, or protection against loss of life or disability, has a place in your financial planning. Make sure that you review this cover annually and especially as your life changes (e.g. when you marry, have children or stop working). You also need to consider your need to insure your property, including your home, household goods and vehicles.

I recommend taking an investment approach to life assurance. This means saving as much money as you can as quickly as possible, so that you can create your own asset base to protect yourself and your family. In an ideal world, you should aim to build up sufficient assets so that you can fund yourself if you are no longer able to work because of illness or disability.

Now I realise that this is not easy to do and that it will take most of us many years to accomplish this goal, but it should still be your aim. My reasoning is that life and disability insurance is very expensive in South Africa, especially if you have your own policy rather than insurance through your employer's retirement fund. In most instances, if you have sufficient capital, the premiums you would have paid for insurance would be better utilised within your investments. Very few people manage to reach this stage, but it is worth aiming for.

When you are young and have no financial dependants, you should aim to insure yourself against illness and disability. You will only need life cover to pay off any debts that you may have. This will change as you get older, but we will cover that a bit later in this chapter. The idea here is to make sure that you have the minimum type of cover required for your stage of life.

Before you decide to buy any insurance or medical aid, make sure that you get at least three quotes from three different product providers. The prices will vary tremendously and you can often benefit greatly from shopping around. More importantly, collecting as much information as you can will help you to make a more informed decision.

If you are working for a company, especially a larger business, you might have life, disability and dread-disease insurance cover, as well as medical aid, provided as part of your package. If this is the case, make sure you understand what is covered. In most cases, the cover provided by employee packages is *much* cheaper than you can get on your own.

MEDICAL AID

The first cover you should buy is a medical aid or hospital plan. At the very least, you should buy a hospital plan that will ensure you will be placed in a private hospital and that your expenses will be covered in the event of a major accident or emergency medical condition. I wouldn't want to trust my health to a state hospital in the event of a serious accident, even though there are some that provide good care.

It's important to be aware that even hospital plans have to provide what are known as prescribed minimum benefits (PMBs). These are defined benefits legislated by government to ensure that all medical scheme members have access to certain minimum health services, regardless of the benefit option they have selected.

In terms of the Medical Schemes Act, medical schemes – including hospital plans – have to cover the costs related to the diagnosis, treatment and care of any emergency medical condition, a limited set of 270 defined medical conditions and 25 defined chronic conditions. Many people don't know this, and so they don't reap the full benefit from their medical scheme or hospital plan.

Medical cover is expensive in South Africa and there are many reasons to be sceptical about medical aids, but this is one cost you should always pay. As you get older, you might consider buying a more comprehensive medical plan, particularly if you plan to start a family, as pregnancy, delivery and children's illnesses can be very expensive. By the same token, when you are elderly, your medical costs will inevitably rise more than your other lifestyle costs, so make sure that you are well covered.

I recommend using one of the large medical aid providers so that you can be sure that they will have the money to pay your claims when required.

DISABILITY PROTECTION

When you are young, the one real risk you need to protect against is an accident or other event that leaves you permanently disabled and, therefore, unable to work. Can you imagine the strain on your family if you are in an accident at age 25 that leaves you bedridden and unable to care for yourself? The emotional and financial burden can be greater than most families can bear.

This means you should take the responsibility for your own financial well-being as soon as you start earning a salary. In order of priority, take out a medical aid, then disability cover and then worry about savings.

For disability cover, I recommend the option of buying an income-replacement policy instead of a policy that pays a capital amount for disability cover. For example, if you earn R10 000 a month, try to buy a policy that will replace as much of your monthly income as possible until you are 65. I prefer this route because you have no idea how your mental capacities might be affected if you are disabled, and therefore you should rather ensure that you get paid a monthly income for the remainder of your working life.

It is generally not possible to get disability insurance beyond age 65 or 70, so you will still need to save for 'retirement'. This means you will need to ensure that your disability income is sufficient to cover your expenses *and* savings. If you are young, this cover is not too expensive (but still not cheap!), so try to ensure that you also get paid a lump sum in addition to your income replacement.

For example, if you earn R10 000 a month, try to buy a policy that pays out a monthly income as well as an additional lump sum. This capital should be used to cover expenses such as remodelling your home if you are in a wheelchair, buying a different car or paying off any debts that you have.

As you get older and your savings increase, you can cancel or reduce the lump-sum portion of the policy if you have sufficient capital, but try to maintain your disability cover until you stop working.

LIFE COVER

Life cover becomes very important when you have financial dependants. For most of us, this means when you have children. This type of cover is quite cheap when you are young and in good health, so try to take out a policy as early in life as possible.

When determining how much life cover to buy, start with your debts and work your way from there to your monthly expenses and then on to your preferences (such as private schooling, for example). So, if you have a home mortgage of R2 million and vehicle debt of R200 000, you should ensure that your life cover pays this off if you die. This is the absolute minimum, because you don't want your spouse saddled with paying off the bond and your car in addition to looking after children as a single parent.

If you can afford to do so, try to ensure that your family will also have sufficient capital to replace your lost income. It's quite simple to work out: simply multiply your annual income by 25 to determine the lump sum they need. So, if you earn R250 000 per year, then multiply this by 25 and you get R6.25 million, which is the amount of life cover that you should have in addition to the value of your outstanding debts. The lump sum that your family receives might seem like a large amount, but this will only replace what you are earning now. It won't cover the extra costs that might be needed – for example, to hire an *au pair* if your spouse still works.

I sometimes speak to men who say that after their deaths they don't want their wives to remarry as wealthy women. From my experience, even young widows don't simply find new husbands at the drop of a hat. They are usually too busy grieving and looking after their children to worry about finding a new spouse, especially one who will be willing to marry into a family.

The important thing to keep in mind is that those families who are financially independent are least damaged by the trauma of losing a father or mother, so try to ensure that you provide for your family properly.

CRITICAL ILLNESS

This is the most complicated aspect of life assurance policies and the one most subject to dispute when it comes to paying claims, so you need to do your homework here. Treatment for heart attacks, cancer, stroke, coronary artery bypass surgery, Alzheimer's disease, blindness, deafness, organ transplants and various terminal illnesses is costly, so do ensure that you are adequately covered. It is important to get this cover when you are young and healthy, because it will be expensive or impossible to get this cover if you are unhealthy.

SHORT-TERM INSURANCE

This is the insurance that you buy to protect yourself when property you own is lost, damaged or stolen. (This form of insurance is called ‘short term’ to distinguish insurance on property or for limited time periods from open-ended insurance on someone’s life. This is a historical convention; the lines between the different types of insurances have blurred over time.) Most commonly, we take out insurance for our vehicles, household items, buildings and other property that we own. Fortunately, this industry is quite transparent, and you can specify items that must be insured and the value of these items. If you act honestly and only claim for the events and items for which you are insured, you have a good chance of being paid out.

Often people try to save money on their insurance premiums by not disclosing the full facts of their situation to the insurance company, and then when they claim, their payment is less than expected. Sometimes the claim is even declined. This frequently happens when people insure their vehicles and say that they do not drive for work purposes. If they then have an accident driving for work, the claim can be repudiated. It always makes sense to provide full disclosure to your insurance company to protect yourself when you need it most.

There are some good ways to save money on short-term insurance, especially if you are prepared to take some of the financial risk yourself. For example, if you insure your car, the insurer will ask you to take some of the financial risk for the vehicle yourself. This is called your excess. Normally it will be a fixed amount, such as R5 000, or a percentage, such as 5%, of the claim value.

I always opt for the maximum excess possible, *e.g.* R20 000, which means that I will have to pay the first R20 000 of any claim before the insurer will start paying out. Taking on maximum excess helps protect the insurer from those people who claim unnecessarily or fraudulently for small claims and tells the insurer that I am going to file a claim only for major events – and these happen less frequently than small-claims-type events. This means that insurers give me a great rate for my insurance and I know that I will be covered if something major happens (*e.g.* my car is written off in an accident). You must ensure that you have sufficient money saved to pay for your excess in the event that you do have an accident, and you should only adjust your excess with the insurance company once you have the money saved. Remember that in the event of a claim, you must pay your excess first. Only then will your claim be paid out.

Another way to lower your short-term insurance costs is to reduce the

possibility of claims through proactive management of your risks. For example, ensure that all the windows in your house have burglar bars, that your garden has motion-detector beams and that you have a proper alarm linked to an armed response company. This will make it more difficult to break into your home, which is safer for you and makes you less of a risk to the insurance company – and that means your premium will be lower.

Your insurance premiums will go up once a year because the replacement value of most items that you insure will increase. You can help to offset this premium increase by ensuring that the value of your vehicle is reduced at the same time, because it is the one item that depreciates every year in replacement value.

There are some annoying details to take care of with regards to your insurance – it's tedious stuff, but you can save money by keeping certain principles in mind. Most importantly, if you underinsure the value of your property, the insurance company will not pay out the full value of your claim – this applies both to your house itself and to its contents. If you insure your household contents and the replacement value is R1 million but you take out cover for only R500 000, then you have taken only 50% insurance. So, if you have a claim for R100 000, the insurer will pay only 50% of the claim because you have taken 50% of the risk. This is important to understand because it is a frequent source of complaints about the industry. Remember, too, that if you underinsure your house and it burns to the ground, for example, you're going to have a difficult time trying to rebuild it, because there simply won't be sufficient funds to do so.

One benefit that is standard on all domestic insurance policies is public liability. This costs very little (R5 per month) but can prove valuable in unforeseen events. For example, if you have a dog and it runs into the street and causes damage to someone's property, your public liability insurance will pay out. People tend to forget about this cover, but it is in your policy for a reason.

DIRECT OR BROKER-BOUGHT INSURANCE?

There are quite a few large direct insurance companies that sell insurance via call centres and the internet. They claim to offer lower insurance premiums because they do not 'pay the middleman'. In my experience, their premiums are often the same when you compare apples with apples. Their premiums appear lower because they provide less cover. Also, some of these companies have a track record of repudiating a high level of submitted claims on a technicality.

I think it's better to get your insurance via an experienced broker who uses large, reputable insurers. If you insist on going directly to an insurance company,

do so only for simple items such as your car and household contents – I would not trust my business insurance to a call centre agent.

In the interests of full disclosure, my company owns a significant share of a large insurance brokerage, so I obviously have faith that they add real value to their clients.

11

Taxes, Trusts and Wills

This chapter deals with what many feel is the mysterious world of taxes and estate planning. My purpose here is to cover the most relevant general principles you should follow when making decisions about these aspects of your finances.

I am an investment specialist and not a tax or legal expert. In this chapter I have simplified things in order to focus on the most important issues. If you find yourself needing a will or trust, I recommend that you speak to an expert so that you get the best advice for your particular situation. Specific tax rates are not included here, as these rates change over time. Speak to an expert for up-to-date tax information.

TAXES

Since the late 1990s, SARS has done its best to simplify the rules for taxpayers. The net effect of the changes is that there are limited ways for salary earners to legitimately reduce their income tax burden.

These days it is largely a waste of time to structure your salary package to save tax – there are no loopholes left. Rather than waste time and money trying to avoid tax, I suggest that you save as much money as you can in your retirement fund or retirement annuity. You get substantial tax relief if you contribute to a retirement fund or RA, so make sure you take full advantage.

If you earn commission or operate your own business, there is more scope to manage your tax. I would suggest, however, that you don't attempt to be too aggressive with your tax planning. If your purpose is to build your wealth, saving tax cannot be your first priority. For example, I often meet commission earners who drive very expensive cars that are replaced every three years. When I ask them why they do this, they tell me that they can write off a portion of the interest on the vehicle loan against tax. This is missing the point. In fact, these car owners are paying a lot of interest on a depreciating item, so they really aren't gaining any benefit from reducing their taxes.

I also meet investors who, on the advice of their accountant or tax advisor, have made shocking investments because they can save on tax. We should be clear on this point: most tax advisors are useless investment advisors, and schemes like tank containers, aeroplane syndicates and farming ventures that are sold to you on the basis that they will save tax are generally terrible investments.

When I make a decision to select an investment, tax is one of my last considerations. I will always default to an investment that delivers good returns, even if they are taxable. In my experience, tax-efficient investments rarely outperform taxable investments even on an after-tax basis.

For individuals who pay maximum income and capital gains tax, I usually recommend an endowment for their long-term savings. This is one of the few investments that can be a tax-efficient investment without compromising your investment growth. The reason for this is that endowments have a special tax dispensation. When capital is invested in an endowment, it is treated as a separate investor and is taxed according to a predetermined income tax and capital gains tax rate. Whether the person who invests money in the endowment is in a high tax bracket or a low tax bracket is irrelevant – the endowment pays its own tax.

At the time of writing, endowments pay lower income and capital gains tax than individuals. The benefit for those who pay the maximum tax rate is that they can draw out their money from the endowment (after a minimum of five years) without needing to pay any tax because it has already been paid. Note that life assurance agents often say that your investment in an endowment is tax-free, which is not true, but an endowment can be a tax-effective investment.

If you are not in the highest tax bracket for income and capital gains tax, however, an endowment is a less attractive savings vehicle. And in any case, I need to reinforce the point that the endowment itself must be a good investment irrespective of the tax benefit, which means it should be very low cost, transparent and provide investment choice.

High-quality, tax-efficient investments do exist, but they are rare and usually have a limited lifespan, as SARS is not fond of wealthy people deriving any undue tax advantages.

Capital gains tax

The implementation of capital gains tax (CGT) has made long-term investments less attractive because investors must now pay tax on their capital gains. The Treasury have long argued that this form of tax is necessary to stop people trying to be too creative with their income tax by camouflaging their income as capital gains. CGT is charged at a much lower rate than income tax for individuals, so it is still preferable to make profits on long-term investments rather than pay income tax on investments. This is another reason why an investment in shares is better than investments in bank accounts or money market accounts. You pay income tax on interest, but you will generally pay CGT if you are a long-term investor in shares. Note that some people prefer to buy and sell their shares actively – that is, over periods of months rather than years. This can lead to capital profits being treated as income, which means the investor must pay income tax.

Dividends tax

When a company makes a profit, it might decide to pay some of that profit to the owners of the company (shareholders). The payment to shareholders is called a dividend and the amount paid to each shareholder will be determined by the amount of shares that owner holds. Dividends are usually paid in cash, but sometimes shareholders are offered shares to the same value as the cash instead. Dividends do attract tax called dividends tax. This tax is considered a withholdings tax because the company that pays the dividend will pay a portion

of your dividend directly to SARS on your behalf. Dividends tax is currently charged at a flat rate of 15% on all dividends, although this rate could increase in future.

WILLS

Every single adult should have a will, which is a legal document stating how you wish your possessions to be disposed of when you die. Unless you own absolutely nothing and have no children, I cannot think of one exception to this rule. Whether you are a young person who is just starting your career or an elderly retiree, if you die without a will, you are creating massive problems for those you leave behind.

When you die, everything you own effectively becomes part of your estate. This is a legal requirement and your estate has to be closed down (wound up) according to a fixed procedure. There is a large body of law that relates to wills and estates, so it's worth ensuring that you have a legally valid will. A will ensures that your assets will be distributed in the way you wanted – you do not want to leave this decision to the judgement of a bureaucrat.

Upon your death, your estate will be reported to a division of the High Court called the Master of the High Court: Deceased Estates, which supervises the administration of estates. Most people simply call this the Master's Office. There are quite a few branches of the Master's Office around the country. At the time of writing, they are in Pretoria, Cape Town, Pietermaritzburg, Grahamstown, Bhisho, Umtata, Bloemfontein, Kimberley, Mmabatho/Mafikeng, Johannesburg, Polokwane, Nelspruit, Durban, Port Elizabeth and Thohoyandou. Your estate will fall under the closest Master's Office to your place of residence at the time of your death.

Sadly, some of the Master's Offices are apparently very inefficient and are in a state of decline. I say this based on the hundreds of complaints I have heard from clients who have lost a loved one and from professionals who deal with deceased estates. Whenever there is massive inefficiency, there is always opportunity for corruption, so please ensure that you have a valid will.

Who should draft a will for you?

I recommend that you get a specialist to draft your will for you. In most instances these specialists are either lawyers or tax experts. A specialist will typically charge between R500 to R1 000 for a will if your finances are uncomplicated. It's true that all the big banks offer to give you a will for free, but I don't recommend that you go this route.

First, the banks will always appoint themselves as the executors. Executors are the people who carry responsibility for winding up your estate. The problem

with the banks is that they usually charge full fees for doing this (3.5% of the value of the estate + VAT) and they are usually inefficient. They struggle to retain competent and experienced staff, which means your estate could be wound up by an inefficient bank dealing with an inefficient Master's Office. You can probably predict the result.

Second, you are better off having your will drafted by a specialist who has substantial experience with wills. Many financial advisors, lawyers and tax advisors will tell you that they can draft a will. Sadly, if they are not experienced, they are likely to make a mistake, which can prove very costly. I recommend that you only deal with a firm that has an estate department. In most instances this would either be a specialist estate planning business or a law firm with an estate planning division. When it comes to winding up your estate, they are more likely to know the intricacies of estate law and what problems to avoid when drafting the will.

What should be in your will?

This is not a comprehensive list of criteria, but it should give you a good idea of what to think about when drawing up your will.

Ensure that you keep a good record of all your assets so that your executor knows what to look for. It is good practice to keep this list of your assets with someone outside of your home – for example, a family member, your financial planner, lawyer or accountant. Your will should stipulate what will happen to your assets when you die, so you need to think long-term.

If you are young and appoint your parents as the beneficiaries of your will, make sure there is an alternative beneficiary if they die before you do. If you are married, the same applies if you leave everything to your spouse. You can leave specific items or assets to specific people (such as a wedding ring to your daughter or a painting to your sister, etc.). You can then stipulate that a certain portion of the remaining part of your estate (called residue) is allocated to each beneficiary. For example, 50% of your assets could go to each of your two children (if you are unmarried).

It may be tempting to create lots of rules governing how your money must be distributed, but you need to be careful with this. I have met a few families who inherited farms or houses in Zimbabwe that they were not allowed to sell because of a stipulation in a will. The person who created the will did not foresee that the country would collapse, which caused financial harm to their loved ones. In general, I would not stipulate that certain assets (especially fixed property) may not be sold by beneficiaries, unless the stipulation is for a limited period of

time only. You cannot foresee what will happen 20 or 50 years after your death. It would be very sad if you stipulated that your heirs may never sell the family holiday house on the coast and in 50 years' time it is eroded away due to global warming. This might sound far-fetched, but it is currently happening to properties in some coastal areas around the world.

You should also appoint an executor of your estate; this person has the responsibility to wind up your affairs. You don't need to appoint a professional executor in your will; you could appoint a trusted family member or close friend (but do ask their permission first). That person can then appoint professionals to assist with the estate once you have passed away, which enables them to negotiate a good fee and to appoint people who are competent.

Another suggestion is to appoint a trusted family member or friend as a co-executor with a professional. Alternatively, you can appoint a professional person to be your executor, although this is not my preferred route, because firms and their employees change or disappear over the course of time.

If you have young children or if you have a large estate, you might want to leave the bulk of your assets to a trust. You can then nominate those who should benefit from the trust. The trustees of the trust can then make decisions on your behalf for your beneficiaries. Trusts are discussed in more detail later in this chapter.

It is also very important to appoint guardians for your children in the event that both of their parents die (e.g. in a car accident). That way you ensure that someone you trust will be raising them, and they won't be bouncing around in the system. Be sure that you nominate a first and second choice, in case something happens to the first choice of guardian, and be sure to ask their permission first. You will want your appointed guardians to agree to take on such a large responsibility.

Your will must be dated and should clarify that you cancel (revoke) all previous wills. You can change your will at any time and the most recent (valid) will is the one that should be used.

You need to sign every page of your will, and the last page must be signed at the end of the typed or written words without leaving blank spaces between the words and the signature. It must also be witnessed by at least two people who must sign in your presence and in the presence of one another. To avoid a situation in which there is potential conflict of interest, don't ask someone who is likely to receive something from your estate to be a witness to your will.

How often should you review your will?

You should review your will at least every year. Things can change dramatically in a short period of time and it is important to ensure that your beneficiaries are still alive, that your assets are updated and that your executor is still capable. You should also change your will immediately if there is a death in the family, if you get married or divorced or have a child, or when any other major event takes place in your life.

TRUSTS

Trusts originated in the time of the crusades (12th and 13th centuries) when English knights left their homes to fight abroad. These crusades usually lasted many years and there was no certainty that the knight would return. He therefore left his assets to someone he trusted and who was expected to manage his estate (literally his farms) for the benefit of the knight and his family. In modern times, a trust is an arrangement where property is held by one party (the trustee) for the benefit of another (the beneficiary). A trust can be created either while you are alive or only at the time of your death if this is stipulated in your will.

If you place money in a trust, you are legally giving the money to a new 'person' and therefore you have no right to the money thereafter unless you are a beneficiary of the trust. Trusts are usually run by trustees who manage the affairs of the trust according to a written document (called a trust deed), which stipulates how the money should be managed and who should benefit from it. Trust law is complex and you need to ensure that your trust is correctly structured and was created for the right reasons.

Historically, some wealthy people used trusts as a tax shelter or as a way to hide their assets from spouses, creditors and the government. SARS has worked hard to make sure that trusts are not used as tax shelters by levying high taxes on them. This makes it unattractive to use a trust if your only purpose is to avoid tax. In addition, if you place money in a trust because you are in financial difficulty, it is likely that the courts will cancel the transfer of the money or assets to the trust and allow your creditors access to your money or assets.

Why should you have a trust?

The best reason to have a trust is to ensure that your assets can be transferred to your nominated beneficiaries in the way that you want. For example, if you are reasonably wealthy and have young children, you would most likely not want them to inherit your wealth at a very young age if you die.

This means you might create a trust in your will, which will take ownership of your assets until your children are of the right age to inherit. Trusts are quite flexible, so you can ensure that your children (or their guardians) receive an income when they are under age so that they can be properly cared for.

Another good reason to have a trust is if you have a large estate (e.g. assets exceed liabilities by at least R8 million) and would like your assets to benefit a few generations of your family. For example, if you are 60 years old and have a

28-year-old child and a two-year-old grandchild, you might want to ensure that you can provide for the grandchild's education. A trust would be an ideal way to ensure that your wishes are met.

There are many situations in which it is sensible to make use of trusts. However, as with your will, make sure that you get proper advice and that your trust is correctly structured to meet your wishes.

What should be in a trust?

Every trust should appoint at least three trustees who will be responsible for ensuring that the trust is managed correctly according to the trust deed. It is normal for a husband and wife to be two of the trustees, while the third should always be a completely independent person.

Trusts can be deemed to be invalid if you have too few trustees or if there are no independent trustees. For large trusts, I prefer that at least two trustees are independent in addition to the two founding spouses.

It is important to note that trustees cannot do anything illegal and may object to immoral instructions too. There is a case in South Africa where a wealthy woman wanted her trust to fund white children's education bursaries exclusively. The trustees found this objectionable and the universities that were supposed to educate the children declined the money on the grounds of racial discrimination.

Always ensure that you have a 'plan B' as an alternative to your original plan in your trust. For example, if you choose your only child as the sole beneficiary, make sure that you choose an alternative beneficiary in the event that your child dies before you do. You may choose an established charity (such as the SPCA, your former school or university, and so on) as your final alternative in the event that your other nominated beneficiaries are not able to receive the income.

12

Getting Help from Financial Professionals

Given the title and purpose of this book, you might be wondering why I have included a chapter about getting help from financial professionals. To be frank, dealing with your financial affairs on your own can be stressful and lonely, especially in difficult times. During these times, it often makes sense to tap into the knowledge of a coach to give you an outsider's view on your situation and how it can be improved. The world of sport, especially individualistic sports like golf and tennis, provides great examples of how a coach can help a professional. There is very little that a coach can teach the world's best golfers and tennis players; however, they all make use of coaches because they need an objective, experienced person whom they trust to point out the little things they are doing wrong. The world of money is very similar, and therefore a chapter on how best to use financial professionals is appropriate for everyone – from a financial novice to a financial expert.

There's a misconception among many people that having money will solve all your problems and get rid of your worries, but the truth is, having money is stressful. When you are younger and don't have much money, your greatest concern is how to pay the bills every month. And while this is a difficult situation, most people manage to survive this stage of life relatively unscathed. As you get older and start accumulating assets, however, your life becomes more complicated. You are now in a position where bad decisions could cost you real money – sometimes more than you earn in a year – and usually at a time when you can least afford mistakes. And all of this is why you need a good financial advisor: it could mean the difference between financial freedom and financial slavery.

Finding a good advisor is similar to finding a good business or life partner. You need the right combination of skills, trust and chemistry for the relationship to work. The right financial advisor will help you to develop a long-term plan that is tailored to your individual situation and that encompasses your goals for the short term and for the remainder of your life. He or she will guide you in

making the right financial decisions – and, more importantly, in avoiding the mistakes that could set you back for years. Your advisor should be able to educate you about your finances so that you can make informed decisions about your future.

And it's not about you going to an expert because you don't have a clue about money. Even financially sophisticated people use advisors as a sounding board for their financial decisions. There are so many variables that can have an impact on your investments that it often makes sense to test your ideas with an objective expert to ensure that you are making the right decisions.

Don't believe me? Well, even billionaire Warren Buffett has Charlie Munger, vice chairman of Berkshire Hathaway Corporation, as his trusted advisor, and it is Munger who tells Buffett when he is making mistakes. And that's the role you need your financial advisor to play. It's your advisor's job to tell you when you are being irrational or unrealistic in your expectations.

Given the amount of trust you need to invest in your advisor, it's important to take the time to ensure that you are dealing with the right person or company – someone who's a good fit for you and your needs.

WHAT MAKES A GREAT FINANCIAL ADVISOR?

Financial advisors need a rare combination of abilities in order to be really good in their role.

First, they need to have an in-depth technical knowledge of their field. This means they need a strong academic foundation, preferably at postgraduate level. In South Africa, one can obtain a postgraduate diploma or a B.Comm honours in financial planning at a few South African universities. These should be the minimum academic qualifications for any professional financial advisor.

Malcolm Gladwell, the acclaimed author of *Outliers: The Story of Success*, says that you need 10 years or 10 000 hours of practice to become an expert in any field, and this is certainly true for financial planning. If you have not been a practising financial planner for at least three years, you should consider yourself an apprentice rather than the finished item. All Certified Financial Planners have this minimum level of experience in addition to the academic qualifications.

Second, great financial advisors also need strong interpersonal skills, specifically the ability to teach, coach and empathise with clients. There are many advisors who are technically strong but who have limited understanding of the human being behind the numbers. They are not able to convey their knowledge to their clients in the most meaningful ways, nor are they able to help them emotionally, which means that they are not really helpful at all.

As I've been saying throughout this book, successful investing is not a difficult business to understand, but it is very difficult to implement in practice. This is because stock markets are driven by emotions in the short term and all investors will feel emotional pressure in different market cycles. Great financial advisors have the ability to help their clients deal with the emotional aspect of investing, as they can coach them through the bad times and manage their irrational expectations in the good times.

The world's best sports stars are often said to possess an 'X factor' that separates the good from the great. By definition, this is not something that can easily be described – otherwise it would have a better name! For financial advisors, the X factor is the ability to convey the fact that you care, that you are trustworthy and that you understand the person you are helping. This isn't something that can be taught or described in a textbook.

All of us have met someone and either just clicked with that person or, conversely, felt that something was 'off'. It's hard to explain, but you know how you feel. And it's the same with financial advisors – you'll work best with an advisor who has the ability to put his or her clients at ease and to make them feel cared for.

This often leads to some interesting situations where financial advisors unintentionally become marriage counsellors, life coaches or grief counsellors in bad times. People will automatically open up to trusted advisors, especially because they are dealing with personal financial matters. The best advisors know when to draw the line in these situations: they cannot become unlicensed psychologists – they must always remain financial advisors.

It's all about you

Your financial advisor should always focus on providing the advice and recommendations that best suit your individual requirements. Good advisors are objective in their advice and will always tell you what you need to hear, including the bad news. They should be interested in your overall financial position and focused on your long-term well-being – this is the major difference between a good advisor and a sales agent.

Agents are in the business of selling products for a living. Of course, there is nothing wrong with this, and agents can be quite useful when you have a specific requirement, but never confuse an agent with a financial advisor. They are very different.

Also remember that having a financial plan that you never execute is like having a custom-designed fitness programme: it won't do you any good unless

you start exercising. Some people need help sticking to their exercise goals and ensuring that they implement them in a disciplined way, and so they employ the services of a personal fitness trainer. The same applies to financial planning. You need a plan that is suited to your requirements and then you need to implement it. This is where your advisor adds the most value: he or she can help you avoid irrational decisions in difficult market conditions and help you maintain your financial discipline when necessary.

Your financial coach

Essentially, your financial advisor should play the role of financial coach. An advisor is there to help you manage your finances properly, and will continuously educate you and coach you through the plan he or she is helping you implement.

The reason all professional sportspeople have coaches is that they need someone to help them refine their techniques and motivate them when times are tough. Similarly, a financial advisor should facilitate the formulation of your plan and help you stick to it in difficult personal circumstances or poor market conditions.

Your advisor is not there to make you rich! At best, an advisor can help you improve your financial position, but it is up to you to save and generate capital. It is likely that you will be tempted to make some emotion-driven financial decisions at some points in your life, and it is during these times that your advisor should add the most value.

Investment options offered by your advisor are there to help generate long-term capital growth that exceeds inflation. Properly managed, these investments should limit your financial risk and provide a nest egg for your retirement. These investments are highly unlikely to turn you into the next Bill Gates, which means that advisors won't make you rich – ever. If you meet an advisor who promises to make you rich, you are talking to a con artist.

HOW WILL YOUR FINANCIAL ADVISOR DEVELOP A PLAN FOR YOU?

There are many different approaches to managing your financial affairs. For any good plan, there are three areas of focus:

- your tolerance for investment risk;
- your objectives; and
- your financial position.

Your tolerance for investment risk

We will all react differently when we are in the unfortunate situation in which an investment has lost money. Some people will react quite rashly – they may sell their remaining investments and invest only in ‘safe’ assets, such as cash and gold. At the other end of the risk spectrum, some people will not be happy unless they know their assets are in high-risk investments that have the best chance of achieving high levels of growth. For them, a loss is part of the game and will not bother them at all, provided they understand why the investment made a loss. It is important that you and your advisor understand your tolerance for risk so that you are appropriately invested. Risk-tolerance measurement tools have become quite sophisticated and can give you an accurate indication of your own risk tolerance. As a note of caution, your investment risk tolerance is totally unrelated to your tolerance for physical risk (e.g. skydiving or motor racing, etc.).

Your objectives

Any good plan for your finances needs to take cognisance of your goals and objectives. For example, if you have a high tolerance for investment risk, a large exposure to shares may be an acceptable investment choice for you, but only under the right circumstances. If you are planning to buy a home in two years’ time with your savings, a share investment, which should be made for five years or longer, is not your best option.

Your financial position

Your financial position, often called your financial capacity, relates to your current financial standing. A good plan needs to take into account how much income you earn, how much you save, and the value and composition of your assets and debt. Finally, your plan needs to account for your future spending plans to determine how your current position should be adjusted to meet those goals.

FINDING THE RIGHT FINANCIAL ADVISOR

Look for a specialist

Let's imagine that you have a septic gall bladder that needs removing immediately. Would you toddle down to the local pharmacy and ask the pharmacist for advice? No – you'd call an ambulance and get to casualty as soon as possible so that the skilled surgeon on call can perform the operation.

Sadly, however, many people don't take the same approach when it comes to their financial health, often putting their finances in the hands of anyone whose business card reads 'Financial Advisor' or 'Wealth Manager'. But you cannot rely on titles alone; it's vital to find out what your advisor's qualifications are. If you want someone who knows their stuff, you need a Certified Financial Planner (CFP). A CFP is a globally recognised qualification and is widely acknowledged as the minimum standard for professional advisors in South Africa. Unfortunately, the law does not require all financial advisors to be CFPs. This means your 'financial advisor' could be a complete novice with one month of training. Ask to see the person's qualifications.

Where do financial advisors work?

In addition to qualifications, a financial advisor's place of work can also provide clues about his or her skill and experience.

Life assurance companies employ thousands of agents across the country, all of whom earn their living as commission earners. This means they have every incentive to sell investment products to the public as fast as possible. As a result, only a small percentage of these agents are CFPs. Typically, agents who work for life assurance companies are contractually bound to sell a high proportion (if not 100%) of that company's products.

Retail banks employ bank brokers who work in the branch and assist clients who walk in asking for advice. These brokers also have a restricted range of products that they can sell, but they generally offer more choices than a life assurance agent. Not all bank brokers are highly qualified professionals. They also earn a living from commission, which is not the most desirable method of remuneration for a long-term investment. There are some excellent bank brokers, but many survive in their positions only because they work for the bank, not because they are good advisors. You must ask lots of questions about the products offered by the broker before you take that person's advice. Don't trust the broker simply because he or she works for the bank.

Private banks tend to employ wealth managers to advise their wealthier clients about their investments. As a rule, private banks are more selective when employing their staff, so there is a good chance that their employees are reasonably experienced and qualified. But remember that these wealth managers work for the bank and not for their clients. This means that you can't keep your advisor if the bank promotes them or if they leave the bank. This is a common problem for private banking clients – their advisors change too often, which is disruptive and unsettling.

Independent advisors are not affiliated with any product provider, bank or life assurance company. Most independent advisors work in smaller companies or work for themselves. It is impossible to categorise all independent advisors into one group – some independents are highly skilled, ethical advisors, while others will be commission-chasing sharks.

In order to differentiate between the good advisors and the dodgy ones, you will need to ask them about their qualifications and remuneration models, and you will also need to investigate their business processes and support systems. There are some good advisors who operate on their own with an administrative assistant; however, you need to question their succession planning. What happens if, say, your advisor dies in an accident? Who is going to assist you in future? Advisors who are concerned about building sustainable businesses that provide continuity to their clients are generally more professional in their outlook, and this will bode well for their attitude towards you and your money. If your advisor is registered with the Financial Services Board (FSB), is a CFP and has an external compliance officer (who ensures that laws and regulations are properly followed), you have some assurance that the advisor is probably on the right track. The FSB is the financial regulator in South Africa, and anyone who gives financial advice to clients must be registered with the FSB. Indeed, you should be deeply concerned if your advisor is not registered with the FSB.

The major concern with small, independent advisory businesses is the lack of systems and infrastructure at their disposal. Many of these businesses are not professionally managed, which can lead to poor service and administration. It is also important to find out if your advisor has proper back-up: is there another advisor to help you if something happens to your current advisor?

How do financial advisors charge for their services?

Initial (upfront) fees on investments are unfair to investors – there is little justification for an advisor to charge you an upfront percentage on your investment. Initial fees are justifiable only when the advisor charges you a fixed

rand-based fee for advice. That means the fee should not be determined by the size of the assets involved. Ongoing (annual) fees that adjust with the value of the investment are fairer. That way, the advisor earns more when your money grows.

Other financial professionals you might need

A good **tax specialist** can help you when you have specific tax issues and need expert advice. A competent financial advisor will have a reasonable knowledge of tax but might not know how to complete tax returns and is unlikely to be qualified to draw up in-depth estate plans and do other complex tax structuring.

Similarly, tax practitioners are not necessarily well versed in investing or assurance. I often find that tax practitioners who give investment advice aren't knowledgeable enough, nor do they spend enough time researching what is best for the client.

An **asset manager** is paid to manage money according to a specific set of instructions. These instructions are known as a mandate, which stipulates how the asset manager can invest money, what investments can be bought and what type of risk can be taken with the money. Most asset managers have sophisticated asset-management tools that enable them to manage many different portfolios as if they were all one portfolio. This means that a typical asset manager would group different types of clients together into categories and then manage each of these categories as one portfolio. There are very few asset managers that will actually manage a portfolio specifically for you, even though their marketing message might tell you differently. In personality, most asset managers are very intelligent and highly qualified, but they might not have the best bedside manner, nor do they have the time to understand all aspects of their clients' financial objectives. In addition, asset managers have absolute faith in their own abilities and are generally convinced that their approach to money is the best solution for most problems.

This means that it might be difficult for a client to explain his or her requirements to an asset manager, and there is no guarantee that the client will end up with the best solution. A large part of successful investing relates to the client's understanding of investments so that he or she is comfortable with the risks and potential rewards.

I have met a number of unhappy clients who worked with an asset manager who didn't explain the relative merits of an investment to them and therefore invested them incorrectly due to a lack of communication. Good financial advisors are not asset managers; they need to look at the broader picture and cannot be married to a particular segment of the market, such as equities or bonds.

Estate planners/lawyers play a vital role in setting up proper estate plans for people. They should work hand in hand with financial advisors to ensure that their clients' affairs are correctly structured and will be managed according to their clients' wishes when they pass away. Estate planners can save significant tax for clients and their beneficiaries.

Insurance agents/life assurance agents do have a role to play in financial planning, but it's important to understand that they are not financial planners. They work for a product provider and they are primarily concerned with managing your financial risks that arise from death, disability and illness. They are not usually qualified to manage or advise you on investments and, on the whole, aim to sell you products rather than develop long-term plans for you.

WHAT TO KEEP IN MIND WHEN LOOKING FOR A FINANCIAL ADVISOR

1. Look for someone who meets the minimum criteria for a good financial planner. This means the person must be a Certified Financial Planner, and you can find a full list of them at www.fpi.co.za.
2. Find out if the advisor specialises in a particular field, such as investments, risk or estate planning.
3. Find out how the advisor charges, and remember that there are very few great financial advisors who earn upfront commission. Financial planning is a long-term business and your advisor should be incentivised to look after you for many years, not just for one deal.
4. Try to meet with a minimum of three different potential advisors so that you can compare them. You need to feel comfortable with the person you choose since you might be working together for decades – you must get along with each other! The best financial advisors are able to build long-term relationships of trust, so it's worth spending the time to find the right professional for you.

You will know you've found a good financial advisor when you can answer all of the following questions with a resounding 'yes':

- Do you get the feeling that your advisor understands you?
- Is there a good 'match' between you and your advisor?
- Do you feel comfortable discussing personal issues with your advisor?
- Do you really understand how your money is being invested?
- Does your advisor provide all recommendations to you in writing?

13

Money and Relationships

If you are in a serious relationship, money issues are bound to arise at some point. And these issues are, without doubt, one of the leading causes of relationship troubles.

If you are married or living with your partner, it's important that you have an understanding of how each of you manages money. And you need to discuss it, not just make assumptions based on your own personal philosophies.

It is rare to find that both parties in a relationship have a similar attitude towards money. In most instances, one person is more careful about spending while the other person is more carefree with money. This is usually fertile ground for conflict – conflict that can be avoided through proper communication and planning.

OUR PERSONAL RELATIONSHIP WITH MONEY

The way you grew up has an enormous impact on your relationship with money, and that is unlikely to change over your lifetime. But this 'hard-wired' relationship with money can be managed, provided you are honest about your money issues.

Those who grew up in a poor home will view money very differently from those who were raised in a wealthy home. However, this does not mean that all wealthy people will have the same attitude towards money. In fact, children from the same family often have completely different attitudes as far as money is concerned. And when you combine two different styles of money management, as most of us do in our relationships, it makes for some interesting conflicts and other issues.

When I meet a couple for the first time, I often find that one partner is largely uninvolved with the finances, while the other feels burdened by money decisions. And when we start discussing attitudes towards money, there is frequently an underlying tension in the relationship because of it. I am regularly surprised by the dysfunctional way that couples deal with money. Here are some examples:

- One partner feels that the other spends too much money, so to avoid conflict, the 'spender' hides his or her spending.
- A lawyer makes his wife pay for daily expenses with her own income, while he 'takes care' of the savings. (One wonders if he is hiding money.)
- A chartered accountant leaves all the investment decisions to her unemployed husband to bolster his confidence.
- A successful career woman earns far more than her husband but is afraid to tell him this for fear of emasculating him.
- A high-powered executive constantly changes jobs because she gets bored or hates her boss and resigns, which places financial stress on the family when she is out of a job.
- An entrepreneur starts a new business and takes a mortgage against the family home as funding without telling his wife.
- A wife is blissfully ignorant of the family finances and investments because her husband deals with all of them.

I know psychologists would have a field day analysing these dynamics, but that's not my area of expertise. My focus is on helping these couples find

solutions to their money problems. This chapter offers some pointers that you might find useful if you find yourself having money issues in your relationship.

DEVELOP A PLAN FOR YOURSELVES AS A COUPLE

As a starting point, the traditional roles played by men and women with regard to money are totally flawed. In the past, men would control the money, while women controlled the household. There are so many problems with this that I am not going to list them. The point is that very often women are much better at budgeting and controlling money than men.

In my house, my wife is responsible for the budgeting and I manage the investments. However, we are both well informed about what is happening with all aspects of our money. I have a good idea of how our budget is structured, while my wife knows how and where our money is invested. We have also agreed on a long-term investment strategy that we are both comfortable with. In the event that I die before my wife, she is unlikely to change our investments.

This works incredibly well in our family, because I tend to be more impulsive with spending. My wife is also very analytical and is known to our friends as the 'spreadsheet queen'. In other families, the roles might be completely reversed, but it is vital that each partner is well informed about the overall plan and that both are comfortable with what is happening.

I have met many widows (because wives tend to outlive their husbands) who throughout their married lives left all the financial decisions to their husbands. Needless to say, they find the loss of their husband especially traumatic because they are suddenly confronted with a range of financial decisions that they are not prepared for.

I recall one woman whom I met when she was 70 and whose husband had died a few months earlier. She had been a senior politician and was highly capable, but had not worried about finances for 40 years. She did not even know how to write a cheque or where her money was invested. It took us eight months to get a full understanding of where everything was and another 12 months to get her up to speed on her investments.

In most instances where there are money issues in a relationship, at least one of the partners feels out of control in relation to money, which means there is an underlying anxiety that needs to be managed. I find that couples can control this by developing a long-term plan for themselves.

Each couple should start with their end goal and work backwards from there.

For example, if you are in your late 20s, try to agree on when you would both like to stop working, where you would like to live and what kind of lifestyle you can afford at that time. Once you have the long-term goals defined, you can calculate how much money will be needed to fund those goals. This will determine how much you should save, what you can spend on luxuries and how you should invest your savings.

You both need to agree on the main goals and thereafter each of you can take responsibility for certain aspects of your finances. On a regular basis (monthly, six-monthly or yearly), you should review your plans and how you have progressed towards your goals. It is important that you are both part of the process so that you share a common purpose and can hold each other accountable to your shared goals. This helps the more anxious person because there is a plan in place, while the more relaxed person might realise that there is some work to be done.

INVESTMENT DECISIONS FOR COUPLES

I think it's a bit easier for couples with different attitudes towards money to work together on a budget than it is for both of them to manage their investments separately. First, each partner will have a different level of financial literacy. If one partner is not familiar with investments, it will be difficult for that person to understand and feel comfortable with investment decisions.

Second, each of us has a specific level of risk tolerance when it comes to investments. Some people will be comfortable with investing in a higher-risk investment, and when it loses money for a time, they will maintain their composure. Other people simply cannot tolerate any kind of loss on an investment for any period of time. In this situation, couples need to figure out how they are going to manage their investments so that both parties can sleep at night.

It is important to understand that your tolerance for investment risk is a hard-wired psychological trait that is unrelated to other traits. You might be a natural risk taker when it comes to fast cars, skydiving and other physical activities, but you might still be totally risk averse with investments. In fact, the issues around risk are only really problematic when one of the partners has an extreme attitude to risk – either too risk prone or too risk averse. To an extent, you can achieve some balance in your attitude to investment risk by increasing your knowledge levels about investing.

Note that I am not suggesting that both partners need to study investments. When I meet a married couple for the first time, I always try to meet both of them for the first few meetings. I normally insist that they are both part of the planning process when we determine how their capital will be invested and what sort of risk must be taken. If the husband is going to be my main contact, it is still vital that his wife knows, at a high level, what we are doing, how the money is being invested and what could happen if the stock market crashes. This is important because, as a financial advisor, I do not want to meet the wife for the first time only after her husband has died. The whole point of financial planning is to ensure continuity and that the financial impact of a loss in the family is limited.

PLANNING FOR THE WORST: WHAT HAPPENS IF ONE OF YOU DIES?

In modern relationships, fewer people are getting married, but they are still buying houses and creating investments together. In this situation, it is important that you plan and document what will happen if one of you dies. I have seen a few too many situations where a couple buys a home together and one partner dies in an accident. Often the remaining partner is forced to sell the home because there is now only one source of income, which is insufficient to pay the bond. Alternatively, the family of the deceased are not familiar with the financial situation of the couple and a dispute arises around money. It is very clear in such a situation that you need an up-to-date will, but you also need to consider the financial implications of an unplanned death. You might need to take life assurance on each other's lives in addition to creating a will.

It is a fact that married people tend to live longer and happier lives than their single counterparts. The stability that a relationship provides to both individuals is clearly important. Money is such a crucial aspect of our lives that it's vital that you make the effort to ensure that you manage your money in partnership so that it becomes a foundation of your relationship and not a problem area.

14

Financial Blunders to Avoid

After nearly two decades of dealing with money, I have accumulated a sizeable collection of horror stories of how bad financial decisions have harmed, and even destroyed, people's lives. Most of these mistakes can be grouped into a few basic categories, which I have identified below. While this list isn't likely to be all-inclusive, these are the most common mistakes I have encountered. And there is something to be learnt from each of them.

OVERSPENDING AND EXCESSIVE DEBT

Without doubt, the bulk of those who are in constant financial difficulty are people who consistently spend more than they earn. And sadly, the same people seem to make this same error repeatedly over a lifetime, without learning from their past mistakes.

As an objective outsider, I find it terribly frustrating to observe this behaviour, because the solution to the problem seems so simple. I often equate this type of overspending to the behaviour of those who overeat and become obese. Any outsider can tell what the problem is, but that doesn't mean that the person who is in trouble can stop.

I don't profess to understand the intricacies of the mind, but I am convinced that money and psychology are close friends. In a time when access to money plays such a vital role in our lives, it is impossible to separate your innate psychological profile and your relationship with money.

Consider an example. One of my long-standing clients lost her husband to cancer. She had faithfully nursed him through his last days and they had tried to carefully plan her future so that life would be as easy as possible for her. Unfortunately, they could not plan for the depression that she suffered after he died, a depression that was nearly her undoing. And it wasn't just her state of mind that was the problem. What made it worse was that she exhibited her depression through overspending. She started spending money on innocuous items that were small enough in value that they didn't cause alarm until her spending was tallied up. I remember looking through her credit card slips and noticing that she would visit a convenience shop 20 to 30 times a day. Each time she would buy a magazine, a pack of chewing gum or some other similarly low-priced item. To outsiders, she seemed to be coping well with the loss of her husband. However, I realised that she was fast eroding her precious investment capital and would be destitute within months. Fortunately, we managed to overcome the problem through the support of her adult children and some careful financial coaching.

A more common money problem that I observe regularly is excessive debt, frequently related to vehicle purchases. For some reason, many South Africans (men in particular) spend ridiculous amounts of money on cars. We tend to calculate the affordability of vehicles by the amount we can repay on vehicle finance every month. So if we take home R5 000 per month as an income, then a car is 'affordable' if we spend R4 000 repaying the vehicle debt. The fact that we

also have to pay for petrol, insurance, food, clothing and rent is largely ignored.

And even some of the most financially literate people make this mistake. Some chartered accountants I know regularly spend millions every three years on cars. They simply have to own a large SUV because the wife and two kids need the extra space for the rare occasions when friends need to be transported. I am convinced that if we all spent less on cars, our country would have many more homeowners with paid-off homes.

UNDERSPENDING

To younger people who have grown up in financially stable homes or in times of economic prosperity, underspending would be an unthinkable problem. But I have many elderly clients who grew up in the difficult times after World War II, when the world was in a severe depression. They often went hungry as children and many could not afford to go to school. As a result, they grew up preparing for the next depression. They saved every cent 'for a rainy day', and even when they retired as wealthy people, they could not change the habits of a lifetime.

When my wife's grandmother died in her 90s, the family found many unused towels, clothes, cosmetics and other gifts that she had been given during her lifetime. She simply could not bring herself to throw away anything until it had fallen apart. She also could not bring herself to use new towels and linen herself, as she thought this was wasteful. She did not die a pauper, but she certainly lived very frugally.

When I meet clients who have a similar problem with money, I try to encourage them to budget for a single 'luxury' every year. Most often, these clients end up taking children and grandchildren on holidays.

SHORT-TERM THINKING

I often receive emails from younger people who have started working and have ‘invested’ their first bit of savings. The most common question they ask me is, ‘When will my investment go up so that I can sell it to buy a car [or holiday, etc.]?’ I reply honestly and tell them that it could take seven to 10 years, and most of them never contact me again.

In truth, investing in productive assets (those that should appreciate in value by more than the inflation rate) is not an exact science. For example, you could make a sound investment in a great asset and be derailed because terrorists fly into commercial buildings in another country. But this does not mean you should now sell all your investments immediately. On the contrary, you should probably buy more if you can and wait until they recover in value.

The recovery could be a period of months or years, and the patience required is beyond many of us, but it’s especially difficult for younger people. In truth, investing money is simple in concept but awfully difficult in practice. It takes a bit of common sense, some intelligence and a whole lot of patience.

OVERCONFIDENCE WITH INVESTMENTS

I often recall meeting a man – let's call him John – who came to my offices three years after selling his IT business for more than R100 million. John's story was not unusual: he was a successful, intelligent businessman who thought that he could easily manage his investments. But after three years and nearly R11 million in losses, he decided that it was easier for him to run a business than it was for him to manage his money. And, in fact, it took John and me two years to develop a workable business relationship because he could not give up the management of his investments. He needed to control them in the same way he controlled his businesses.

John eventually started another business and used a portion of his capital on that venture, which enabled me to manage the balance of his money for him. I am happy to report that client and advisor are now much happier people and his money is growing again!

I often meet medical specialists (surgeons in particular) as well as advocates and certain engineers who believe that their past success in a different field qualifies them for automatic financial expertise. This belief is especially prevalent if they are mathematically gifted, as they believe markets can be reduced to formulas. Unfortunately, a track record of success in a job that has led to real wealth creation in a certain field does not automatically make one a successful investor. The markets have humbled many intelligent people over hundreds of years, especially those who are overconfident or arrogant.

To be successful with investments, you need to be confident in your abilities, but humble enough to know that you will regularly make mistakes. History's greatest investors often talk more about their (many) mistakes than their successes. In fact, many of them will acknowledge that they worked very hard over many years, but they were also lucky. This type of humility is a key ingredient in long-term investment success.

Arrogance and overconfidence might lead to financial success over a few months or even years, but eventually the markets will humble even the most successful investors. The difference between Warren Buffett and similarly intelligent men from his era, for example, is that he never got caught up in his success. He always reminds people that he was lucky enough to be born at the right time, in the right country, as a male with parents who could afford to pay for his education. This humility means that even when he has a strong conviction in an investment idea, he fully anticipates that he could be wrong and makes

plans to ensure that he will survive if he makes a big error.

Overconfident investors – usually men – start to believe that they can outwit the market and are more intelligent than their peers. This leads them to make highly risky investment decisions that tend to destroy them when they make a mistake. The late Sir John Templeton – a pioneer in both financial investment and philanthropy – maintained that he was correct with 51% of his investment decisions over his lifetime. Considering his astounding success over decades, we should all be prepared to be wrong with every second investment decision we make.

NAIVETY CAUSED BY FEAR OR GREED

Since I started in the investment industry in Cape Town in the mid-1990s, I have seen more than 10 large investment schemes or scams collapse. At the most basic level, these scams convince people to part with their capital because they are fearful or greedy, and unscrupulous operators are experts in playing to these emotions once they have identified which one drives you. This has caused untold damage to many people's lives. In many cases, retirees were the main victims of these events and some of them committed suicide rather than face life without savings.

Many people retire every year with insufficient money. Almost as soon as they have retired, they start searching for one or two investments that might enable them to make up the additional capital they require. For an unscrupulous operator looking to make a quick buck, these people are heaven-sent.

Most of the scams are based on partially believable facts, and property is often used as a cornerstone of the scam. For some reason, investors like to know that their money is going to be invested in a property and that the specific property or properties they are buying are *much* better than anything else in the market. It is our own fear or greed that allows us to deceive ourselves when we are sold a story by the sharks.

Other scams that have worked in the past are sold as high-risk, high-return structured investments. The promoters of these scams claim that the exact nature of these investments must be kept secret so that other people don't find out about them. In addition, they limit access to the investments by making them exclusive so that you have to be 'invited' to invest.

Another variety of scam that has worked well in the past is sold as a pooled investment in a private business (or group of businesses) that is doing very well at the moment. In fact, this business is doing so well that it is expanding rapidly and needs capital to meet its growth obligations. Often these businesses are

described as manufacturing companies that have suddenly landed big orders from new clients and they need money to buy more machinery or raw materials to fulfil the orders. The business is so sure of making a profit from these new orders that it is willing to pay high interest rates (e.g. 25% per year) if you lend it money. These scams are quite risky or tenuous, even though there are businesses in this position that have legitimate orders. I would be very sceptical if someone approached me with this type of proposition. My default view is that this is a scam unless I can be convinced otherwise.

Nothing can take the place of careful, thorough research when it comes to making an investment decision. Read what experts say, and don't be afraid to ask 'stupid' questions or to maintain scepticism in the face of get-rich-quick promises. When a financial commentator writes that they would not invest in something or they would not recommend it or that they cannot understand it, be wary! The person is trying to tell you to treat the investment as you would a swarm of angry bees – avoid it! And for non-experts, the old saying that 'if it sounds too good to be true, then it probably is' applies as well.

BLIND TRUST AND FAMILY ADVICE

In my work as a professional financial advisor, I can't tell you the number of times my clients have told me to 'just go ahead, I trust you'. While this is a lovely compliment to any advisor, it is also scary to hear.

Every investor should ensure that they have some knowledge of how their money is being invested. If you make use of the services of a financial advisor, portfolio manager or stockbroker, make sure that you have a basic understanding of what your advisor is doing. You don't need to be an expert, nor do you need an in-depth knowledge of what is happening, but you should make it your business to know all the basics of what is going on with your finances. This is particularly true when you are relying on family members or close friends to help you with your investments. Remember that it is not rude to ask questions about your own money!

A few years ago, one of my favourite clients called to tell me that his son-in-law was joining a private bank as a wealth manager. My client felt obliged to support his daughter and her husband. We parted ways amicably a few weeks later with a promise that he would be welcomed back if he wanted to rejoin my client list.

After 12 months, he called me to say that he had made a big mistake. He was simply not getting what he wanted from an advisor and felt let down. We agreed that he should stick it out for a few more months before making the decision to return to us. Another nearly 12 months passed, he called on a Monday to tell me that he could no longer continue working with his son-in-law and had given the news to the family the preceding weekend. He hadn't lost any money, but he never felt able to have an open discussion with his son-in-law to discuss his concerns. There are times when friends, family and money can be a powerful combination, but in many instances this is a potent mix for disaster.

BUYING HIGH AND SELLING LOW

Without fail, certain types of investors will avoid the stock market when it is offering great value and will invest only when it is really expensive and due for a crash. Why does this happen?

The stock market offers great value when bad news dominates. Certain types of investors simply cannot ignore this news and because of fear will not invest their money. They will invest only when all the financial news is good and the stock markets have been booming for the last few years. Sadly, we all know what happens after they invest – the market crashes and these investors sell out in a panic at a major loss. This pattern repeats itself every five to seven years, which is just long enough for people to forget the past.

You can be successful with your investments only if you remain invested when the whole world seems to be falling apart. I'm not saying that this is easy to do, but it's the only way to ensure long-term success.

PROCRASTINATION

This is almost self-explanatory, because we all know that nothing good was ever accomplished by procrastinators – in fact, procrastinators tend to accomplish nothing at all! However, procrastination is particularly problematic when it comes to managing money, because your problems literally compound themselves. If you delay paying off your debt or starting to invest your savings, the power of compounded growth will work against you, not for you.

A LACK OF BALANCE

There is never an absolute view with money, especially not with investments. If you want to be a successful saver, you need to ensure that you budget for fun or luxury items too. Without some balance, you might be very disciplined for a limited time, but you will eventually cheat and splurge, and possibly erode or destroy your quality of life.

When making investment decisions, you should try to ensure that you keep a balanced view. For example, if you strongly believe that the stock market is going to crash, don't sell all your shares. Rather reduce your investment in shares, but keep some money invested just in case you are wrong. This should apply to all your money decisions: always try to be balanced.

A FINAL NOTE

Financial matters are complicated only if you allow them to be. If your life is spiralling out of control because of money troubles, you need to realise that you are the cause *and* the solution. No advisor, book or product is going to solve your problems – it has to start with you.

Bibliography

- Botha, Marius, Lee Rossini, Walter Geach, Brian Goodall, Laura du Preez, and Paul Rabenowitz (eds). *The South African Financial Planning Handbook 2012*. Durban: LexisNexis, 2012
- Brinson, Gary P., L. Randolph Hood, and Gilbert Beebower. 'Determinants of Portfolio Performance', *Financial Analysts Journal* 42, no. 4 (July–August 1986): 39–44
- Clason, George Samuel. *The Richest Man in Babylon*. New York: Penguin Books, 1926
- Dimson, Elroy, Paul Marsh, and Mike Staunton. *Credit Suisse Global Investment Returns Yearbook 2012*. Zurich: Credit Suisse Research Institute, 2012
- Eichholtz, Piet M.A. *A Long Run House Price Index: The Herengracht Index, 1628–1973*. Maastricht: University of Maastricht – Limburg Institute of Financial Economics (LIFE), 1994
- Gladwell, Malcolm. *Outliers: The Story of Success*. New York: Little, Brown and Company, 2008
- UBS. *Life Themes: Investing in Volatile Times*. Part 1, *Many Ways to Rome: Comparing Different Investment Approaches*, June 2009
- Vanguard Group. *Dollar cost averaging just means taking risk later*, July 2012
- Wessels, Daniel R. *Towards a Sustainable Retirement Plan*. DRW Investment Research, 2011

Do you have any comments, suggestions or feedback about this book or any other Zebra Press titles? Contact us at talkback@zebrapress.co.za

*

Visit www.randomstruik.co.za and subscribe to our newsletter for monthly updates and news